ENOVA SYSTEMS INC
Form 10-Q
May 14, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ending March 31, 2007

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission file no. 1-33001

ENOVA SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

California	**95-3056150**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*

19850 South Magellan Drive, Torrance, California 90502

(Address of principal executive offices, including zip code)

(310) 527-2800

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.) Yes o No þ

As of May 10, 2007, there were 14,828,000 shares of common stock outstanding.

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ENOVA SYSTEMS, INC.

Enova Systems is a trademark of Enova Systems, Inc. All other brand names or trademarks appearing in this quarterly report on Form 10-Q are the property of their respective holders.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
ENOVA SYSTEMS, INC.
BALANCE SHEETS
As of March 31, 2007 (unaudited) and December 31, 2006 (audited)

		As of March 31, 2007		As of December 31, 2006
ASSETS				
Current assets				
Cash and cash equivalents	$	8,649,000	$	5,612,000
Short term investment				5,000,000
Accounts receivable, net		1,102,000		358,000
Inventories and supplies, net		2,773,000		1,704,000
Prepaid expenses and other current assets		184,000		708,000
Total current assets		12,708,000		13,382,000
Property and equipment, net		665,000		627,000
Ownership interest in joint venture company		1,606,000		1,647,000
Intangible assets		73,000		74,000
Total assets	$	15,052,000	$	15,730,000
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities				
Accounts payable	$	321,000	$	382,000
Deferred revenues		408,000		399,000
Accrued payroll and related expense		307,000		220,000
Other accrued expenses		1,036,000		664,000
Current portion of notes payable		83,000		71,000
Total current liabilities		2,155,000		1,736,000
Accrued interest payable		768,000		735,000
Notes payable, net of current portion		1,275,000		1,295,000
Total liabilities	$	4,198,000	$	3,766,000
Stockholders equity				
Series A convertible preferred stock no par value 30,000,000 shares authorized 2,652,000 shares issued and outstanding Liquidating preference at $0.60 per share, aggregating $1,591,000		1,679,000		1,679,000
		2,432,000		2,432,000

Series B convertible preferred stock no par value 5,000,000 shares authorized 1,185,000 shares issued and outstanding Liquidating preference at $2 per share, aggregating $2,370,000				
Common Stock, no par value 750,000,000 shares authorized 14,828,000 and 14,816,000 shares issued and outstanding, respectively		109,496,000		109,460,000
Common stock issuable		36,000		36,000
Stock notes receivable		(1,149,000)		(1,176,000)
Additional paid-in capital		6,975,000		6,955,000
Accumulated deficit		(108,615,000)		(107,422,000)
Total stockholders equity		10,854,000		11,964,000
Total liabilities and stockholders equity	$	15,052,000	$	15,730,000

See accompanying notes to these financial statements.

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ENOVA SYSTEMS, INC.
STATEMENTS OF OPERATIONS
For the Quarters Ended March 31, 2007 and 2006 (unaudited)

	3/31/2007	3/31/2006
Net revenues		
Research and development contracts	$	$ 264,000
Production	1,543,000	45,000
Total net revenues	1,543,000	309,000
Cost of revenues		
Research and development contracts		290,000
Production	1,383,000	170,000
Total cost of revenues	1,383,000	460,000
Gross profit (loss)	**160,000**	**(151,000)**
Operating expenses		
Research and development	95,000	325,000
Selling, general & administrative	1,328,000	924,000
Total operating expenses	1,423,000	1,249,000
Other income and (expense)		
Interest and financing fees, net	111,000	179,000
Equity loss share of joint venture company losses	(41,000)	(26,000)
Debt extinguishment		920,000
Interest extinguishment		472,000
Total other income and (expense)	70,000	1,545,000
Income (Loss) from operations	(1,193,000)	145,000
Net Income (loss)	$ (1,193,000)	$ 145,000

Basic and diluted earnings (loss) per share	**(0.08)**	0.01
Weighted-average number of shares outstanding/basic and diluted	**14,821,982**	14,783,000

See accompanying notes to these financial statements.

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ENOVA SYSTEMS, INC.
STATEMENTS OF CASH FLOWS
For the Quarters Ended March 31, 2007 and 2006 (unaudited)

	2007	2006
Cash flows from operating activities		
Net Income (loss)	(1,193,000)	145,000
Adjustments to reconcile net loss to net cash used in operating activities		
Debt extinguishment		(920,000)
Interest extinguishment		(472,000)
Depreciation and amortization	74,000	90,000
Equity in losses of equity method investee	41,000	26,000
Issuance of common stock for services	36,000	30,000
Issuance of common stock for bonuses		
Stock option expense	20,000	14,000
(Increase) decrease in		
Accounts receivable	(744,000)	1,399,000
Inventory and supplies	(1,069,000)	2,000
Note receivable related party		
Prepaid expenses and other current assets	524,000	(92,000)
Other assets		
Increase (decrease) in		
Accounts payable	(61,000)	(1,236,000)
Accrued expenses	459,000	(91,000)
Deferred revenues	9,000	
Accrued interest payable	33,000	(7,000)
Net cash provided by (used in) operating activities	(1,871,000)	(1,112,000)
Cash flows from investing activities		
Purchases of short-term securities		(10,000,000)
Sales of short-term securities	5,000,000	
Purchases of property and equipment	(111,000)	(84,000)
Provided by Net (cash used) in investing activities	4,889,000	(10,084,000)
Cash flows from financing activities		
Net increase from line of credit		
Payment on notes payable and capital lease obligations	(8,000)	
Proceeds from notes payable		
Payment to extinguish debt		(165,000)
Net Proceeds from sales of common stock		
Proceeds from stock notes receivable	27,000	
Payments on stock notes receivable		

Net cash provided by (used in) financing activities	19,000	(165,000)
Net increase (decrease) in cash and cash equivalents	3,037,000	(11,361,000)
Cash and cash equivalents, beginning of period	5,612,000	16,187,000
Cash and cash equivalents, end of period	8,649,000	4,826,000
Interest paid	1,400	0
Income taxes paid	0	0

See accompanying notes to these financial statements.

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ENOVA SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 Basis of Presentation

The accompanying unaudited financial statements have been prepared from the records of our company without audit and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not contain all the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position at March 31, 2007 and the interim results of operations for the three months ended March 31, 2007 and cash flows for the three months ended March 31, 2007 have been included. The balance sheet at December 31, 2006, presented herein, has been prepared from the audited financial statements of our company for the year then ended.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions affecting the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. The March 31, 2007 and December 31, 2006 inventories are reported at the lower of cost or market value. Inventories have been valued on the basis that they would be used, converted and sold in the normal course of business. The amounts estimated for the above, in addition to other estimates not specifically addressed, could differ from actual results; and the difference could have a significant impact on the financial statements.

Accounting policies followed by us are described in Note 1 to the audited financial statements for the fiscal year ended December 31, 2006. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted for purposes of the interim financial statements. The financial statements should be read in conjunction with the audited financial statements, including the notes thereto, for the year ended December 31, 2006, which are included in our Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 as filed with the Securities and Exchange Commission.

Basic earnings (loss) per common share is computed using the weighted average number of common shares outstanding. Diluted earnings per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of employee stock options and preferred stock conversions.

The results of operations for the three months ended March 31, 2007 presented herein are not necessarily indicative of the results to be expected for the full year.

Stock Based Compensation

On January 1, 2006, the Company adopted SFAS 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based awards made to employees and directors, including employee stock options and shares issued through its employee stock purchase plan, based on estimated fair values. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of the beginning in 2006. The Company financial statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123(R).

Stock compensation expense recognized during the period is based on the value of share-based awards that are expected to vest during the period. Stock compensation expense recognized in The Company statement of operations for 2006 includes compensation expense related to share-based awards granted prior to January 1, 2006 that vested during the current period based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123. Stock compensation expense in 2006 also includes compensation expense for the share-based awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).

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The Company determination of estimated fair value of share-based awards utilizes the Black-Scholes option-pricing model. The Black-Scholes model is affected by the Company stock price as well as assumptions regarding certain highly complex and subjective variables. These variables include, but are not limited to, the Company expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors.

Stock Based Compensation Issued to Third Parties

The Company accounts for stock based compensation issued to third parties, including customers, in accordance with the provisions of the Emerging Issues Task Force (EITF) Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services* , and EITF 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).*

Under the provisions of EITF 96-18, if none of the Company s agreements have a disincentive for nonperformance, the Company records a charge for the fair value of the stock and the portion of the warrants earned from the point in time when vesting of the stock or warrants becomes probable. EITF 01-9 requires that the fair value of certain types of warrants issued to customers be recorded as a reduction of revenue to the extent of cumulative revenue recorded from that customer. The Company has not given any stock based consideration to a customer.

Stock Option Program Description

For the year ended December 31, 2006, the Company had two equity compensation plans, the 1996 Stock Option Plan (the 1996 Plan) and the 2006 equity compensation plan (the 2006 Plan). The 1996 Plan has expired for the purposes of issuing new grants. However, the 1996 Plan will continue to govern awards previously granted under that plan. The 2006 Plan has been approved by the Company s Shareholders.

Equity compensation grants are designed to reward employees and executives for their long term contributions to the Company and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants are based on competitive practices, operating results of the company, and government regulations.

The maximum number of shares issuable over the term of the 1996 Plan was limited to 65 million shares. Options granted under the 1996 Plan typically have had an exercise price of 100% of the fair market value of the underlying stock on the grant date and expired no later than ten years from the grant date. The 2006 Plan has a total of 3,000,000 shares reserved for issuance, none of which have been granted.

Stock options for the 1996 Stock Option Plan, and the 2006 Stock Option Plan were approved by the stockholders. All stock options have terms of 10 years, except for options issued to employees which have a term of 5 years, and generally vest and become fully exercisable four years from the date of grant. The vesting schedule for stock option grants are generally as follows: 25% of the grant vests upon one year from date of grant with the remainder of the grant vesting in 36 equal monthly installments thereafter.

Quarter ended March 31, 2007

In conjunction with the adoption of SFAS 123(R), the Company elected to attribute the value of share-based compensation to expense using the straight-line method, which was previously used for its pro forma information required under SFAS 123. Share-based compensation expense related to stock options and employee stock purchases was $20,000 for the three months ended March 31, 2007, and was recorded in the financial statements as a component of selling, general and administrative expense.

Share-based compensation expense reduced the Company s results of operations as follows:

	3-21-2007	**3-31-2006**
Income from continuing operations before income taxes	$ 20,000	$ 14,000
Income from continuing operations after income taxes	$ 20,000	$ 14,000
Cash flows from operations	$ 20,000	$ 14,000
Cash flows from financing activities	$	$

Basic and Diluted EPS	$	$

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During the quarters ended March 31, 2007, and 2006 the Company did not grant any stock options
As of March 31, 2007, the total compensation cost related to non-vested awards not yet recognized is $100,000. The weighted average period over which the future compensation cost is expected to be recognized is 30 months. The aggregate intrinsic value of total awards outstanding, is $645,520.

General Option Information

A summary of option activity is as follows:

	1996 Plan Shares	Weighted Average Exercise Price	Weighted Average Contractual Term
Outstanding December 31, 2006	162,000	$ 4.43	7.75
Granted			
Exercised			
Forfeited			
Outstanding, March 31, 2007	162,000	$ 4.43	7.75
Vested Expected to Vest	162,000	$ 4.43	7.75
Exercisable, March 31, 2006	128,000	$ 4.35	7.63

The weighted-average remaining contractual life of the options outstanding at March 31 2007 was 7.75 years. The exercise prices of the options outstanding at March 31, 2007 ranged from $4.35 to $4.95. The weighted-average remaining contractual life of the options outstanding at December 31, 2006 was 7.96 years. The exercise prices of the options outstanding at December 31, 2006 ranged from $4.35 to $4.95. Options exercisable were 128,000 and 119,000 at March 31, 2007 and December 31, 2006, respectively.

Revenue Recognition

The Company manufactures proprietary products and other products based on design specifications provided by its customers.

The Company recognizes revenue only when all of the following criteria have been met:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services have been rendered;
- The fee for the arrangement is fixed or determinable; and
- Collectibility is reasonably assured.

Persuasive Evidence of an Arrangement The Company documents all terms of an arrangement in a written contract signed by the customer prior to recognizing revenue.

Delivery Has Occurred or Services Have Been Performed The Company performs all services or delivers all products prior to recognizing revenue. Professional consulting and engineering services are considered to be performed when the services are complete. Equipment is considered delivered upon delivery to a customer s designated location.

The Fee for the Arrangement is Fixed or Determinable Prior to recognizing revenue, a customer s fee is either fixed or determinable under the terms of the written contract. Fees professional consulting services, engineering services and equipment sales are fixed under the terms of the written contract. The customer s fee is negotiated at the outset of the arrangement and is not subject to refund or adjustment during the initial term of the arrangement.

Collectibility is Reasonably Assured The Company determines that collectibility is reasonably assured prior to recognizing revenue. Collectibility is assessed on a customer-by-customer basis based on criteria outlined by management. New customers are subject to a credit review process, which evaluates the customer s financial position and ultimately its ability to pay. The Company does not enter into arrangements unless collectibility is reasonably assured at the outset. Existing customers are subject to ongoing credit evaluations based on payment history and other factors. If it is determined during the arrangement that collectibility is not reasonably assured, revenue is recognized on a cash basis. Additionally, in accordance with the Securities and Exchange Commission s Staff Accounting Bulletin No. 104 (SAB 104), amounts received upfront for engineering or development fees under multiple-element arrangements are deferred and recognized over the period of committed services or performance, if such arrangements require the Company to provide on-going services or performance. All amounts received under collaborative research agreements or research and development contracts are nonrefundable, regardless of the success of the underlying research.

Revenues from milestone payments are recognized when earned, as evidenced by written acknowledgment from the customer, provided that (i) the milestone event is substantive and its achievement was not reasonably assured at the inception of the agreement, and (ii) our performance obligations after the milestone achievement will continue to be funded by our collaborator at a comparable level to that before the milestone achievement. If both of these criteria are not met, the milestone payment is recognized over the remaining minimum period of our performance obligations under the agreement.

Pursuant to Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board Issue 00-21. EITF Issue 00-21 addressed the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. Specifically, Issue 00-21 requires the recognition of revenue from milestone payments over the remaining minimum period of performance obligations. As required, we apply the principles of Issue 00-21 to multiple element agreements.

The Company recognizes engineering and construction contract revenues using the percentage-of-completion method, based primarily on contract costs incurred to date compared with total estimated contract costs. Customer-furnished materials, labor, and equipment, and in certain cases subcontractor materials, labor, and equipment, are included in revenues and cost of revenues when management believes that the company is responsible for the ultimate acceptability of the project. Contracts are segmented between types of services, such as engineering and construction, and accordingly, gross margin related to each activity is recognized as those separate services are rendered.

Changes to total estimated contract costs or losses, if any, are recognized in the period in which they are determined. Claims against customers are recognized as revenue upon settlement. Revenues recognized in excess of amounts billed are classified as current assets under contract work-in-progress. Amounts billed to clients in excess of revenues recognized to date are classified as current liabilities under advance billings on contracts.

Changes in project performance and conditions, estimated profitability, and final contract settlements may result in future revisions to engineering and development contract costs and revenue.

Recently Issued Pronouncement

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items

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include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company in the first quarter of fiscal 2009. Enova is currently is determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its consolidated results of operations and financial condition.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006.

The Company files federal income tax returns in the U.S. The Company is no longer subject to U.S. state, or non-U.S. income tax examinations by tax authorities for years before 2003. Certain U.S. Federal returns for years 2006 and following are not closed by relevant statutes of limitation due to unused net operating losses reported on those returns. The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company had no changes in the carrying value of its tax assets or liabilities for any unrecognized tax benefits.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 clarifies that fair value is the amount that would be exchanged to sell an asset or transfer a liability in an orderly transaction between market participants. Further, the standard establishes a framework for measuring fair value in generally accepted accounting principles and expands certain disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 157 to have a material impact on its financial statements.

NOTE 2 Notes Payable, Long-Term Debt and Other Financing

Notes payable and long-term debt is comprised of the following:

	March 31, 2007 (unaudited)	December 31, 2006
Secured note payable to Credit Managers Association of California, bearing interest at prime plus 3% per annum in 2005 and through maturity. Principal and unpaid interest due in April 2016. A sinking fund escrow is required to be funded with 10% of future equity financing, as defined in the agreement	$ 1,238,000	$ 1,238,000
Secured note payable to a financial institution in the original amount of $95,000, bearing interest at 6.21%, payable in monthly installments	80,000	88,000
Secured note payable to Coca Cola Enterprises in the original amount of $40,000, bearing interest at 10% per annum. Principal and unpaid interest due now	40,000	40,000
Less current maturities	(83,000)	(71,000)
Long-term portion	1,275,000	1,295,000

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During the quarter ended March, 31, 2006, the Company settled $1,083,000 of principal and $472,000 accrued interest under the secured note payable to the Credit Managers Association of California (CMAC). In consideration for the settlement, the Company paid the beneficiaries $165,000. The Company evaluated this transaction under the guidance set forth in SFAS 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and noted that the extinguishment of these liabilities was consistent with the guidance.

NOTE 3 Shareholders Equity

During the three months ended March 31, 2007, the Company recorded 9,000 shares of restricted common stock as common stock subscribed, valued at $36,000, to the Board of Directors at an average price of $4.00 per share for board meetings and committee meetings during the first quarter of 2007.

During the three months ended March 31, 2007, the Company issued 12,000 shares of restricted common stock to the Board of Directors from common stock subscribed.

Directors receive quarterly compensation at a flat rate of $4,000 in cash and $6,000 in stock valued on the date of the meeting at the average of the closing ask and bid prices. The flat rate is not dependent on the amount or type of services performed by the Directors.

Prior to September, 2005, for each meeting attended in person, each outside director received $2,000 in cash and $4,000 of stock valued on the date of the meeting at the average of the closing ask and bid prices; for each telephonic Board meeting, each outside director received $500 in cash and $500 of stock valued on the date of the meeting at the average of the closing ask and bid prices; and for each meeting of a Board committee attended in person, a committee member received $1,000 in cash and $1,000 of stock valued on the date of the meeting at the average of the closing ask and bid prices. In September, 2005, the compensation structure for Directors was changed. Effective in the fourth quarter of 2005 and the first quarter of 2006, Directors receive quarterly compensation at a flat rate of $4,000 in cash and $6,000 in stock valued on the last business day of the quarter at the average of the closing ask and bid prices. The flat rate is not dependent on the amount or type of services performed by the Directors. Compensation for the chairman of the audit committee is $2,500 per quarter. The two audit committee members each receive $1,250 per quarter, effective March 31, 2006.

All Directors are also reimbursed for out-of-pocket expenses incurred in connection with attending Board and committee meetings.

NOTE 4 Related Party Transactions

During the three months ended March 31, 2007, the Company purchased approximately $396,000 in components, materials, and services from Hyundai Heavy Industries (HHI), a related party. The outstanding payable balance owed to HHI on March 31, 2007 was approximately $107,000.

A relative of the Company s CEO, is a majority owner of a website consulting firm, which provides services (branding) to the Company. During the three months ended March 31, 2007, The Company paid consulting fees and expenses to this firm in the amount of approximately $59,000

NOTE 5 Material Commitments: None

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING STATEMENTS OF EXPECTED FUTURE PERFORMANCE

This Quarterly Report on Form 10-Q contains statements indicating expectations about future performance and other forward-looking statements that involve risks and uncertainties. We usually use words such as may, will, should, expect, plan, anticipate, believe, estimate, predict, future, intend, potential, or continue or the neg or similar expressions to identify forward-looking statements. These statements appear throughout this Quarterly Report on Form 10-Q and are statements regarding our current intent, belief or expectation, primarily with respect to our operations and related industry developments. Examples of these statements include, but are not limited to, statements regarding the following: our future operating expenses, our future losses, our future expenditures for research and development and the sufficiency of our cash resources. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Quarterly Report on Form 10-Q. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us and described in Item 1.A of Part II under the title Risk Factors and elsewhere in this Quarterly

Report on Form 10-Q.

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The following discussion and analysis should be read in conjunction with the unaudited interim financial statements and notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q and with the financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2006.

GENERAL

Enova believes it is a leader in the development and production of proprietary, commercial digital power management systems for transportation vehicles and stationary power generation systems. Power management systems control and monitor electric power in an automotive or commercial application such as an automobile or a stand-alone power generator. Drive systems are comprised of an electric motor, an electronics control unit and a gear unit which power an electric vehicle. Hybrid systems, which are similar to pure electric drive systems, contain an internal combustion engine in addition to the electric motor, eliminating external recharging of the battery system. A hydrogen fuel cell based system is similar to a hybrid system, except that instead of an internal combustion engine, a fuel cell is utilized as the power source. A fuel cell is a system which combines hydrogen and oxygen in a chemical process to produce electricity. Stationary power systems utilize similar components to those which are in a mobile drive system in addition to other elements. These stationary systems are effective as power-assist or back-up systems, alternative power, for residential, commercial and industrial applications.

A fundamental element of Enova s strategy is to develop and produce advanced proprietary software, firmware and hardware for applications in these alternative power markets. Our focus is digital power conversion, power management, and system integration, for two broad market applications vehicle power generation and stationary power generation.

Specifically, we develop, design and produce drive systems and related components for electric, hybrid-electric, fuel cell and microturbine-powered vehicles. We also develop, design and produce power management and power conversion components for stationary distributed power generation systems. These stationary applications can employ hydrogen fuel cells, microturbines, or advanced batteries for power storage and generation. Additionally, we perform research and development to augment and support others and our own related product development efforts.

Our product development strategy is to design and introduce to market successively advanced products, each based on our core technical competencies. In each of our product/market segments, we provide products and services to leverage our core competencies in digital power management, power conversion and system integration. We believe that the underlying technical requirements shared among the market segments will allow us to more quickly transition from one emerging market to the next, with the goal of capturing early market share.

Enova s primary market focus centers on both series and parallel heavy-duty drive systems for multiple vehicle and marine applications. A series hybrid system is one where only the electric motor connects to the drive shaft; a parallel hybrid system is one where both the internal combustion engine and the electric motor are connected to the drive shaft. We believe series-hybrid and parallel hybrid medium and heavy-duty drive system sales offer Enova the greatest return on investment in both the short and long term. We believe the medium and heavy-duty hybrid market s best chances of significant growth lie in identifying and pooling the largest possible numbers of early adopters in high-volume applications. We will attempt to utilize our competitive advantages, including customer alliances, to gain greater market share. By aligning ourselves with key customers in our target market(s), we believe that the alliance will result in the latest technology being implemented and customer requirements being met, with a minimal level of additional time or expense. Additionally, our management believes that this area will see significant growth over the next several years. As we penetrate more market areas, we are continually refining and optimizing both our market strategy and our product line to maintain our leading edge in power management and conversion systems for mobile applications.

In December, 2006, we announced a production contract with the Tanfield Group Plc., which we expect will lead to production of up to 200 units in 2007. We expect that this agreement will help to consolidate our position as a market leader in Europe.

In August, 2006, we entered into a contract with Verizon to design, integrate, and deliver 13 service vans. In 2007, we continue to work actively with Verizon. We believe that working with the 2nd largest fleet operator in North America will generate further exposure in the domestic market, and bring additional focus on our unique fleet solutions.

As part of our continuing strategic relationship with International Truck and Engine Corp (IC Corp), we executed an agreement to produce the nations first 19 hybrid school buses. IC Corp is the nation s largest school bus manufacturer, claiming over 60% of the Domestic Build. In addition to school buses, IC Corp is teaming with Enova to supply hybrid buses to the Commercial Bus Market.

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Throughout the first quarter of 2007, we hosted and visited numerous potential customers from the Pick Up and Delivery, Medium Duty and Heavy Duty markets. Every effort is made to continue to mature these relationships, as we believe that they will eventually lead to viable business relationships.

Enova believes that our business outlook is improving. Greater recognition and strong engineering have allowed us to make several key strides towards sustainable revenue. In conjunction with this expected outlook, we have recently made several key management changes in the past months:

On November 17, 2006, The Company promoted Mike Staran to the position of Executive Vice President. In that role, Mr. Staran is responsible for operations, engineering, sales and marketing, and investor relations.

In January 2007, Corinne Bertrand resigned as Chief Financial Officer. In her place, Jarett Fenton was appointed as Chief Financial Officer.

In February of 2007, John Dexter retired from his position as Director of Operations.

We continue to receive greater recognition from both governmental and private industry with regards to both commercial and military application of its hybrid drive systems and fuel cell power management technologies. Although we believe that current negotiations with several parties may result in development and production contracts during 2007 and beyond, there are no assurances that such additional agreements will be realized.

During the first quarter of 2007, we continued to advance our technologies and products for greater market penetration. We continue to develop independently and in conjunction with the Hyundai-Enova Innovative Technology Center (ITC) progress on several fronts to produce commercially available heavy-duty, series and parallel hybrid drive systems.

During the first quarter of 2007, we continued to develop and produce electric and hybrid electric drive systems and components for First Auto Works of China, International Truck and Engine (IC Corp), Ford Motor Company (Ford), Hyundai Motor Car, US Military, Wright Bus of the United Kingdom, and Tomoe of Japan as well as several other domestic and international vehicle and bus manufacturers. We also were successful in introducing our technology to companies such as Concurrent Technology Corporation (CTC), PUES (Tokyo Research and Development), Verizon, Volvo/Mack, Tanfield/Smith Electric Vehicles and Navistar (International Truck and Engine, IC Corporation). The continued relationships, in addition to our newest customers helped Enova easily surpass, since our inception, the manufacturing of its 900th system. Our various electric and hybrid-electric drive systems, power management and power conversion systems are being used in applications including several light, medium and heavy duty trucks, train locomotives, transit buses and industrial vehicles.

CRITICAL ACCOUNTING POLICIES, JUDGMENTS, AND ESTIMATES

In the ordinary course of business, the Company has made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with accounting principles generally accepted in the United States of America. The Company constantly re-evaluates these significant factors and makes adjustments where facts and circumstances dictate. Estimates and assumptions include, but are not limited to, customer receivables, inventories, equity investments, fixed asset lives, contingencies and litigation. There have been no material changes in estimates or assumptions compared to our most recent Annual Report for the fiscal year ended December 31, 2006

The Company has also chosen certain accounting policies when options were available, including:

Cash consists of currency held at reputable financial institutions.

Inventories are priced at the lower of cost or market utilizing first-in, first-out (FIFO) cost flow assumption. We maintain a perpetual inventory system and continuously record the quantity on-hand and standard cost for each product, including purchased components, subassemblies and finished goods. We maintain the integrity of perpetual inventory records through periodic physical counts of quantities on hand. Finished goods are reported as inventories until the point of transfer to the customer. Generally, title transfer is documented in the terms of sale.

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We maintain an allowance against inventory for the potential future obsolescence or excess inventory that is based on our estimate of future sales. A substantial decrease in expected demand for our products, or decreases in our selling prices could lead to excess or overvalued inventories and could require us to substantially increase our allowance for excess inventory. If future customer demand or market conditions are less favorable than our projections, additional inventory write-downs may be required, and would be reflected in cost of revenues in the period the revision is made.

Stock Based Compensation- Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options and employee stock purchases related to the Company s Employee Stock Purchase Plan (the Employee Stock Purchase Plan) based on their fair values. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), which the Company previously followed in accounting for stock-based awards. In March 2005, the SEC issued *Staff Accounting Bulletin No. 107* (SAB 107) to provide guidance on SFAS 123(R). The Company has applied SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method as of and for the three months ended March 31, 2006. In accordance with the modified prospective transition method, the Company s financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Share-based compensation expense recognized in the Company s Statement of Operations during the three months ended March 31, 2007 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123.

Allowance for Doubtful Accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The assessment of the ultimate realization of accounts receivable including the current credit-worthiness of each customer is subject to a considerable degree to the judgment of our management. If the financial condition of the Company s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Contract Services Revenue and Cost Recognition. The Company is required to make judgments based on historical experience and future expectations, as to the reliability of shipments made to its customers. These judgments are required to assess the propriety of the recognition of revenue based on Staff Accounting Bulletin (SAB) No. 101 and 104, Revenue Recognition, and related guidance. The Company makes these assessments based on the following factors: i) customer-specific information, ii) return policies, and iii) historical experience for issues not yet identified. Under FAS Concepts No. 5, revenues are not recognized until earned.

The Company manufactures proprietary products and other products based on design specifications provided by its customers. Revenue from sales of products are generally recognized at the time title to the goods and the benefits and risks of ownership passes to the customer which is typically when products are shipped based on the terms of the customer purchase agreement. Revenue relating to long-term fixed price contracts is recognized using the percentage of completion method. Under the percentage of completion method, contract revenues and related costs are recognized based on the percentage that costs incurred to date bear to total estimated costs. Changes in job performance, estimated profitability and final contract settlements may result in revisions to cost and revenue, and are recognized in the period in which the revisions are determined. Contract costs include all direct materials, subcontract and labor costs and other indirect costs. General and administrative costs are charged to expense as incurred. At the time a loss on a contract becomes known, the entire amount of the estimated loss is accrued. The aggregate of costs incurred and estimated earnings recognized on uncompleted contracts in excess of related billings is shown as a current asset, and billings on uncompleted contracts in excess of costs incurred and estimated earnings is shown as a current liability.

These accounting policies were applied consistently for all periods presented. Our operating results would be affected if other alternatives were used. Information about the impact on our operating results is included in the footnotes to our financial statements.

RECENTLY ISSUED ACCOUNTING STANDARDS

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. Under

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SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company in the first quarter of fiscal 2009. Enova is currently is determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its consolidated results of operations and financial condition.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006.

The Company files federal income tax returns in the U.S. The Company is no longer subject to U.S. state, or non-U.S. income tax examinations by tax authorities for years before 2003. Certain U.S. Federal returns for years 2006 and following are not closed by relevant statutes of limitation due to unused net operating losses reported on those returns. The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company had no changes in the carrying value of its tax assets or liabilities for any unrecognized tax benefits.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 clarifies that fair value is the amount that would be exchanged to sell an asset or transfer a liability in an orderly transaction between market participants. Further, the standard establishes a framework for measuring fair value in generally accepted accounting principles and expands certain disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 157 to have a material impact on its financial statements.

RESULTS OF OPERATIONS

Net revenues for the three months ended March 31, 2007 were $1,543,000 as compared to $309,000 for the corresponding period in 2006. Net production revenue for the quarter ended March 31, 2007 increased to $1,543,000 from $45,000 in the same period in 2006. This represents a large increase in production revenue when comparing quarter to quarter. Our research and development revenues decreased by $264,000 in the first quarter of 2007. The company did not have any research and development revenues in the first quarter of 2007, though we may realize research and development revenues in the future. In the first quarter of 2006, our revenues derived mostly from contracts with Hyundai Motor Corporation and the State of Hawaii. In addition, we recognized revenues from our project with Wrightbus and Tomoe. In the first quarter of 2007, the company shifted the focus towards production contracts, including arrangements with Verizon, International Truck, and Tanfield.

Cost of revenues consists of component and material costs, direct labor costs, integration costs and overhead related to manufacturing our products. Product development costs incurred in the performance of engineering development contracts for the U.S. Government and private companies are charged to cost of sales for this contract revenue. Cost of revenues for the quarter ended March 31, 2007 increased to $1,383,000 from $460,000 for the same period in 2006, primarily attributable to the increase in sales for the quarter, although we are also experiencing an increase in integration support costs. We anticipate there may be an increase in cost of sales for products due to foreign exchange rate fluctuations of the U.S. dollar versus those currencies of our primary manufacturers.

Internal research, development and engineering expenses decreased in the three months ended March 31, 2007 to $95,000 as compared with $325,000 in the same period in 2006. While we continue to develop several new products such as our post transmission parallel hybrid drive system and enhancements to our diesel generator set, our focus has shifted towards production type arrangements, which accounts for the decrease in our internal research and development costs. We continue to allocate necessary resources to the development of our parallel hybrid drive systems, upgraded proprietary control software, enhanced DC-DC converters and advanced digital inverters and other power management firmware.

Selling, general and administrative expenses increased by $404,000 to $1,328,000 for the three months ended March 31, 2007 from the previous year s comparable period. The increase is attributable to additional engineering and technical staff employed in the first quarter of 2007 as well as increased expense due to stricter regulatory oversight. Further, we have experienced increased costs related to our implementation of a new firm-wide software solution. We have also increased our sales and marketing expenditures and have incurred additional costs associated with improving our internal processes

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to support our goal of becoming a production company. While management continues to explore cost reduction strategies in 2007, it is likely that our selling, general, and administrative expenses will continue to increase in the near future. We put a priority on achieving profitability, although management cannot assure that profitability will be achieved.

Interest income decreased by $68,000 in the first quarter of 2007, when compared to the same period in 2006. This decrease is a result of the Company having a smaller average cash balance for the comparable periods in 2007 and 2006.

We realized a net loss of $1,193,000 in the first quarter of 2007 compared to net income of $145,000 in the first quarter of 2006. The decrease is primarily attributable to the settlement of a portion of the debt outstanding to CMAC, resulting in a gain on settlement in the first quarter of 2006 of $1,392,000.

LIQUIDITY AND CAPITAL RESOURCES

We have experienced cash flow shortages due to operating losses primarily attributable to research, development, marketing and other costs associated with our strategic plan as an international developer and supplier of electric propulsion and power management systems and components. Cash flows from operations have not been sufficient to meet our obligations. Therefore, we have had to raise funds through several financing transactions. At least until we reach breakeven volume in sales and develop and/or acquire the capability to manufacture and sell our products profitably, we will need to continue to rely on cash from external financing sources.

Our operations during the year ended December 31, 2006 were financed by development contracts and product sales, as well as from working capital reserves.

During the quarter ended March 31, 2007, our operations required $1,871,000 more in cash than was generated. We continue to increase marketing and development spending as well as administrative expenses necessary for expansion to meet customer demand. Accounts receivable increased to $1,102,000, more than triple the balance at December 31, 2006 (net of write-offs). The increase is due to our increased sales volume in the first quarter of 2007.

Inventory balances increased by $1,069,000 when comparing the balances at March 31, 2007 and December 31, 2006. This represents a 63% increase in the inventory balance between the two periods. We have increased our materials purchasing volume during in the first quarter of 2007 to support our current sales order volume, as well as anticipated increases in future sales volume.

Prepaid expenses and other current assets decreased by net $524,000 at March 31, 2007 from the December 31, 2006 balance of $708,000, or 74%. The Company elected to transfer all Certificate of Deposit balances to a money market account, resulting in a decline in the accrued interest receivable. In addition, vendor prepayments of $143,000 for the Verizon van project were realized with product delivery.

Fixed assets increased by $38,000, net of depreciation and writeoffs, at March 31, 2007, when compared to the December balance of $627,000. In the first quarter of 2007, the Company purchased $111,000 in new property and equipment. The Company recognized $74,000 worth of depreciation expense for the quarter.

Equity method investments decreased by $41,000 in the first quarter of 2007 from a balance of $1,647,000 at December 31, 2006, reflecting a pro-rata share of losses attributable to our forty percent investment interest in the Hyundai-Enova Innovative Technology Center (ITC). For the quarter ended March 31, 2007, the ITC generated a net loss of approximately $102,500 resulting in a charge to us of $41,000 utilizing the equity method of accounting for our interest in the ITC.

Accounts payable decreased in the first quarter of 2007 by $61,000 to $321,000 from $382,000 at December 31, 2006.This decrease is attributable to increased materials purchasing at year end 2006 to support our delivery to Tomoe Manufacturing. In the current quarter, we have increased purchasing to support current sales orders as well as anticipated future orders however, these orders have either already been paid, or not yet been received.

Deferred revenues increased at March 31, 2007 by $9,000, when comparing to the December 31, 2006 balance of $399,000. This difference represents the net effect of the Company realizing revenue that had been deferred in December, combined with additional revenue, which, having been billed or collected, could not yet be recognized as revenue as per the relevant accounting guidance.

Accrued payroll and related expense increased by $87,000 or 40% at March 31, 2007, when compared to the balance reported at December 31, 2006. This increase is attributable to an increased headcount, as well as an accrual for salaries on March 31, 2007, which straddles our pay period.

Other accrued expenses increased by $372,000 for the three months ended March 31, 2007 from the balance of $664,000 at December 31, 2006, primarily due to the accrual of professional services, software implementation, and other such fees, as well as accruals for certain un-invoiced inventory purchases.

Accrued interest increased by $33,000 for the quarter ended March 31, 2007, an increase of 4% from the balance of $735,000 at December 31, 2006. The increase is due to interest related to borrowings under our software lease, as well as additional interest accrued related on other debt instruments.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

None.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were not effective.

In particular, as of March 30, 2007, we did not maintain effective controls over the inventory pricing, tracking, and the reserve analysis process. This control could result in a misstatement to cost of sales that would result in a material misstatement to the annual and interim financial statements that would not be prevented or detected. Our independent registered public accounting firm, PMB Helin Donovan, concluded that these significant deficiencies constituted a material weakness in our internal controls. Our management also determined that these deficiencies constitute a material weakness that impacted our disclosure controls and procedures.

Changes in Internal Controls over Financial Reporting

There were no changes in internal control over financial reporting period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We may from time to time become a party to various legal proceedings arising in the ordinary course of business. As of May 10, 2007 and during the quarter ended March 31, 2007, we were not involved in any material legal proceedings.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors as previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

ITEM 6.

EXHIBITS

31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002

31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 14, 2007

ENOVA SYSTEMS, INC.
(Registrant)

/s/ Jarett Fenton

By: Jarett Fenton, Chief Financial Officer

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