ENOVA SYSTEMS INC
Form 10-Q
November 12, 2010

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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 September 30, 2010

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)*

1560 West 190th Street, Torrance, California 90501

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

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

As of October 31, 2010, there were 31,431,564 shares of common stock outstanding.

ENOVA SYSTEMS, INC.
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ENOVA SYSTEMS, INC.
BALANCE SHEETS

	September 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,478,000	$ 13,078,000
Short term investments	200,000	200,000
Accounts receivable, net of allowance for doubtful accounts of $31,000 as of September 30, 2010 and December 31, 2009	1,275,000	1,442,000
Inventories and supplies, net	4,509,000	5,605,000
Prepaid expenses and other current assets	351,000	263,000
Total current assets	15,813,000	20,588,000
Long term accounts receivable	215,000	
Property and equipment, net	1,260,000	1,363,000
Intangible assets, net	57,000	60,000
Total assets	$ 17,345,000	$ 22,011,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 416,000	$ 415,000
Deferred revenues	54,000	357,000
Accrued payroll and related expenses	803,000	277,000
Other accrued liabilities	919,000	1,287,000
Current portion of notes payable	66,000	68,000
Total current liabilities	2,258,000	2,404,000
Accrued interest payable	1,135,000	1,074,000
Notes payable, net of current portion	1,290,000	1,286,000
Total liabilities	4,683,000	4,764,000
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 as of September 30, 2010 and December 31, 2009	530,000	530,000
Series B convertible preferred stock no par value, 5,000,000 shares authorized; 546,000 shares issued and outstanding; liquidating preference at $2 per share as of September 30, 2010 and December 31, 2009	1,094,000	1,094,000
Common Stock no par value, 750,000,000 shares authorized; 31,432,000 and 31,404,000 shares issued and outstanding as of September 30, 2010 and December 31, 2009, respectively	144,075,000	143,995,000
Additional paid-in capital	8,764,000	8,336,000

Accumulated deficit	(141,801,000)	(136,708,000)
Total stockholders equity	12,662,000	17,247,000
Total liabilities and stockholders equity	$ 17,345,000	$ 22,011,000

The accompanying notes are an integral part of these financial statements.

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ENOVA SYSTEMS, INC.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Revenues	$ 1,904,000	$ 2,890,000	$ 4,887,000	$ 4,154,000
Cost of revenues	1,615,000	2,532,000	4,225,000	3,724,000
Gross income	289,000	358,000	662,000	430,000
Operating expenses				
Research and development	483,000	310,000	1,166,000	899,000
Selling, general & administrative	1,520,000	1,308,000	4,548,000	4,373,000
Total operating expenses	2,003,000	1,618,000	5,714,000	5,272,000
Operating loss	(1,714,000)	(1,260,000)	(5,052,000)	(4,842,000)
Other income and (expense)				
Interest and other income (expense)	(36,000)	(24,000)	(41,000)	(128,000)
Loss from non-consolidated joint venture				(4,000)
Total other income (expense)	(36,000)	(24,000)	(41,000)	(132,000)
Net loss	$ (1,750,000)	$ (1,284,000)	$ (5,093,000)	$ (4,974,000)
Basic and diluted loss per share	$ (0.06)	$ (0.06)	$ (0.16)	$ (0.24)
Weighted average number of shares outstanding	31,430,000	20,969,000	31,417,000	20,904,000

The accompanying notes are an integral part of these financial statements.

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ENOVA SYSTEMS, INC.
STATEMENTS OF CASH FLOWS
(Unaudited)

	For the Nine Months Ended September 30,	
	2010	**2009**
Cash flows from operating activities:		
Net loss	$ (5,093,000)	$ (4,974,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Inventory reserve	221,000	378,000
Depreciation and amortization	409,000	463,000
Loss on asset disposal		6,000
Equity in losses of non-consolidated joint venture		10,000
Gain from dissolution of non-consolidated joint venture		(6,000)
Issuance of common stock for director services		135,000
Issuance of common stock for employee services	71,000	148,000
Stock option expense	428,000	329,000
(Increase) decrease in:		
Accounts receivable	167,000	(1,022,000)
Inventory and supplies	875,000	1,742,000
Prepaid expenses and other current assets	(88,000)	(93,000)
Long term accounts receivable	(215,000)	
Increase (decrease) in:		
Accounts payable	1,000	237,000
Deferred revenues	(303,000)	109,000
Accrued payroll and related expenses	526,000	6,000
Other accrued liabilities	(368,000)	(531,000)
Accrued interest payable	61,000	62,000
Net cash used in operating activities	(3,308,000)	(3,001,000)
Cash flows from investing activities:		
Purchases of short-term investments		(200,000)
Maturities of short-term investments		2,000,000
Proceeds from the dissolution of non-consolidated joint venture		137,000
Purchases of property and equipment	(277,000)	(111,000)
Net cash provided by (used in) investing activities	(277,000)	1,826,000
Cash flows from financing activities:		
Payments on notes payable	(24,000)	(54,000)
Proceeds from the exercise of stock options	9,000	4,000
Net cash used in financing activities	(15,000)	(50,000)

Net decrease in cash and cash equivalents	(3,600,000)	(1,225,000)
Cash and cash equivalents, beginning of period	13,078,000	5,324,000
Cash and cash equivalents, end of period	$ 9,478,000	$ 4,099,000
Supplemental disclosure of cash flow information:		
Interest paid	$ 5,000	$ 5,000
Assets acquired through financing arrangements	$ 26,000	$ 57,000
Net assets acquired in exchange for Enova s interest in joint venture:		
Inventory	$	$ 1,075,000
Prepaid expenses and other current assets	$	$ 104,000
Reduction of related party payable, net of receivable	$	$ 32,000

The accompanying notes are an integral part of these financial statements.

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ENOVA SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
(Unaudited)
Three and nine months ended September 30, 2010 and 2009

1. Description of the Company and its Business

Enova Systems, Inc. (Enova We or the Company) changed its name in July 2000. The Company was previously known as U.S. Electricar, Inc., a California corporation, which was incorporated on July 30, 1976. The Company is a globally recognized leader as a supplier of efficient, environmentally-friendly digital power components and systems products, in conjunction with associated engineering services. The Company s core competencies are focused on the commercialization of power management and conversion systems for mobile and stationary applications.

2. Summary of Significant Accounting Policies

Basis of Presentation Interim Financial Statements

The financial information as of September 30, 2010 and 2009 and for the three and nine months ended September 30, 2010 and 2009 is unaudited but includes all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair statement of its financial position at such dates and the operating results and cash flows for those periods. The year-end balance sheet data was derived from audited financial statements, and certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to SEC rules or regulations; however, the Company believes the disclosures made are adequate to make the information presented not misleading.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although management believes these estimates and assumptions are adequate, actual results could differ from the estimates and assumptions used.

The results of operations for the interim periods presented are not necessarily indicative of the results of operations to be expected for the fiscal year. These interim financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2009, which are included in the Company s Annual Report on Form 10-K for the year then ended.

Fair Value of Financial Instruments

The carrying amount of financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, approximate fair value due to the short maturity of these instruments. Short-term investments consist of certificates of deposits. The carrying value of all other financial instruments is representative of their fair values. The recorded values of notes payable and long-term debt approximate their fair values as interest rates approximate market rates.

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 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 Rendered 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. In certain instances, the customer elects to take title upon shipment.

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 for 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. 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.

We recognize revenue from milestone payments over the remaining minimum period of performance obligations.

The Company also 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 received are classified as current assets. Amounts billed to clients in excess of revenues recognized to date are classified as current liabilities 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.

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.

Several other factors related to the Company may have a significant impact on our operating results from year to year. For example, the accounting rules governing the timing of revenue recognition related to product contracts are complex and it can be difficult to estimate when we will recognize revenue generated by a given transaction. Factors such as acceptance of services provided, payment terms, creditworthiness of the customer, and timing of delivery or acceptance of our products often cause revenues related to sales generated in one period to be deferred and recognized in later periods. For arrangements in which services revenue is deferred, related direct and incremental costs may also be deferred.

Inventory

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.

Inventory reserve

We maintain an allowance against inventory for the potential future obsolescence or excess inventory. 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.

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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.

Deferred Revenues

The Company recognizes revenues as earned. Amounts billed in advance of the period in which service is rendered are recorded as a liability under deferred revenues. The Company has entered into several production and development contracts with customers. The Company has evaluated these contracts, ascertained the specific revenue generating activities of each contract, and established the units of accounting for each activity. Revenue on these units of accounting is not recognized until a) there is persuasive evidence of the existence of a contract, b) the service has been rendered and delivery has occurred, c) there is a fixed and determinable price, and d) collectability is reasonable assured.

Warranty Costs

The Company provides product warranties for specific product lines and accrues for estimated future warranty costs in the period in which revenue is recognized. Our products are generally warranted to be free of defects in materials and workmanship for a period of eighteen months from the date of delivery, subject to standard limitations for equipment that has been altered by other than Enova personnel and equipment which has been subject to negligent use. Warranty provisions are based on past experience of product returns, number of units repaired and our historical warranty incidence over the past eighteen month period. The warranty liability is evaluated on an ongoing basis for adequacy and may be adjusted as additional information regarding expected warranty costs become known.

Stock Based Compensation

We measure the compensation cost for stock-based awards classified as equity at their fair value on the date of grant and recognize compensation expense over the service period for awards expected to vest, net of estimated forfeitures.

See Note 10 *Stock Options* for further information on stock-based compensation expense.

3. Inventory

Inventory, consisting of materials, labor and manufacturing overhead, is stated at the lower of cost (first-in, first-out) or market and consisted of the following at:

	September 30, 2010	December 31, 2009
Raw Materials	$ 4,427,000	$ 6,341,000
Work In Progress	895,000	132,000
Finished Goods	189,000	111,000
Reserve for Obsolescence	(1,002,000)	(979,000)
Total	$ 4,509,000	$ 5,605,000

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4. Property and Equipment

Property and equipment consisted of the following at:

	September 30, 2010	December 31, 2009
Computers and software	$ 589,000	$ 556,000
Machinery and equipment	879,000	795,000
Furniture and office equipment	98,000	98,000
Demonstration vehicles and buses	650,000	507,000
Leasehold improvements	1,348,000	1,348,000
Construction in process	51,000	8,000
	3,615,000	3,312,000
Less accumulated depreciation and amortization	(2,355,000)	(1,949,000)
Total	$ 1,260,000	$ 1,363,000

Depreciation and amortization expense was $406,000 and $459,000 for the nine months ended September 30, 2010 and 2009, respectively, and within those total expenses, the amortization of leasehold improvements was $201,000 and $202,000 for the nine months ended September 30, 2010 and 2009, respectively. Depreciation and amortization expense was $135,000 and $143,000 for the three months ended September 30, 2010 and 2009, respectively, and within those total expenses, the amortization of leasehold improvements was $67,000 for each of the three months ended September 30, 2010 and 2009.

5. Other Accrued Liabilities

Other accrued liabilities consisted of the following at:

	September 30, 2010	December 31, 2009
Accrued Inventory Received	$ 162,000	$ 334,000
Accrued Professional Services	245,000	395,000
Accrued Warranty	512,000	558,000
Total	$ 919,000	$ 1,287,000

Accrued warranty consisted of the following activities during the nine months ended September 30:

	2010	2009
Balance at beginning of year	$ 558,000	$ 545,000
Accruals for warranties issued during the period	346,000	273,000
Warranty claims	(392,000)	(136,000)
Balance at end of quarter	$ 512,000	$ 682,000

Accrued warranty consisted of the following activities during the three months ended September 30:

	2010	2009
Balance at beginning of quarter	$ 493,000	$ 530,000

Accruals for warranties issued during the period	139,000	202,000
Warranty claims	(120,000)	(50,000)
Balance at end of quarter	$ 512,000	$ 682,000

6. Intangible Assets

Intangible assets consist of legal fees directly associated with patent licensing. The Company has been granted three patents. These patents have been capitalized and are being amortized on a straight-line basis over a period of 20 years.

Intangible assets consisted of the following at:

	September 30, 2010	**December 31, 2009**
Patents	$ 93,000	$ 93,000
Less accumulated amortization	(36,000)	(33,000)
Total	$ 57,000	$ 60,000

Amortization expense charged to operations was $1,000 and $3,000 for the three and nine months ended September 30, 2010 and 2009, respectively.

7. Notes Payable, Long-Term Debt and Other Financing

Notes payable consisted of the following at:

	September 30, 2010	December 31, 2009
Secured note payable to Credit Managers Association of California, bearing interest at prime plus 3% (6.25% as of September 30, 2010), and is adjusted annually in April through maturity. Principal and unpaid interest due in April 2016. A sinking fund escrow may 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 $23,000, bearing interest at 11.70%, payable in 36 equal monthly installments of principal and interest through October 1, 2010	1,000	8,000
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 on demand	40,000	40,000
Secured note payable to a financial institution in the original amount of $39,000, bearing interest at 4.99% per annum, payable in 48 equal monthly installments of principal and interest through September 1, 2011	10,000	18,000
Secured note payable to a financial institution in the original amount of $38,000, bearing interest at 8.25% per annum, payable in 60 equal monthly installments of principal and interest through February 19, 2014	27,000	32,000
Secured note payable to a financial institution in the original amount of $19,000 bearing interest at 10.50% per annum, payable in 60 equal monthly installments of principal and interest through August 25, 2014	16,000	18,000
Secured note payable to a financial institution in the original amount of $26,000 bearing interest at 7.91% per annum, payable in 60 equal monthly installments of principal and interest through April 9, 2015	24,000	
	1,356,000	1,354,000
Less current portion	(66,000)	(68,000)
Long-term portion	$ 1,290,000	$ 1,286,000

As of September 30, 2010 and December 31, 2009, the balance of long term interest payable with respect to the Credit Managers Association of California note amounted to $1,112,000 and $1,054,000, respectively. Interest expense on notes payable amounted to approximately $65,000 and $66,000 during the nine months ended September 30, 2010 and 2009, respectively. Interest expense on notes payable amounted to approximately $22,000 during each of the three months ended September 30, 2010 and 2009.

8. Revolving Credit Agreement

The Company entered into a secured revolving credit facility with a financial institution (the Credit Agreement) for $200,000, which is secured by a $200,000 certificate of deposit. The facility expired on June 30, 2010 and was renewed for a period of 3 years and 6 months with the same terms on July 1, 2010 with an expiration of December 31, 2013. The interest rate on a drawdown from the facility is the certificate of deposit rate plus 1.25% with interest payable monthly and the principal due at maturity. The financial institution also renewed the $200,000 irrevocable letter of credit for the full amount of the credit facility in favor of the Company s landlord, Sunshine Distribution LP, with respect to the lease of the Company s corporate headquarters at 1560 West 190th Street, Torrance, California.

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9. Stockholders Equity

During the nine months ended September 30, 2010 and 2009, the Company issued shares of common stock valued at $71,000 and $283,000, respectively, to directors and employees as compensation based upon the trading value of the common stock on the date of issuance. During the three months ended September 30, 2010 and 2009, the Company issued shares of common stock valued at $24,000 and $69,000, respectively, to directors and employees as compensation based upon the trading value of the common stock on the date of issuance.

10. Stock Options

Stock Option Program Description

As of September 30, 2010, 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, executives and directors 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 2006 Plan has a total of 3,000,000 shares reserved for issuance, of which 1,706,000 shares were available for grant as of September 30, 2010. All stock options have terms of between five and ten years and generally vest and become fully exercisable from one to three years from the date of grant. As of September 30, 2010, the Company had 1,316,000 options outstanding which were comprised of issuances under the 1996 Plan and the 2006 Plan of 73,000 and 1,243,000, respectively.

As of September 30, 2010, the total compensation cost related to non-vested awards not yet recognized is $470,000. The weighted average period over which the future compensation cost is expected to be recognized is 17 months. The aggregate intrinsic value represents the total pretax intrinsic value, which is the difference between the Company s closing stock price on the last trading day of the third quarter of fiscal 2010 of $0.65 and the exercise price times the number of shares that would have been received by the option holders if they had exercised their options on September 30, 2010. This amount will change based on the fair market value of the Company s stock.

The following table summarizes information about stock options outstanding and exercisable at September 30, 2010:

	Number of Share Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2009	1,410,000	$	2.10	7.65	
Granted		$			