

ENOVA SYSTEMS INC  
Form 10-Q  
August 14, 2008

Table of Contents

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

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

For the quarterly period ending June 30, 2008

or

**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**

*(State or other jurisdiction of  
incorporation or organization)*

**95-3056150**

*(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  No

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  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

As of July 17, 2008, there were 20,633,791 shares of common stock outstanding.

**ENOVA SYSTEMS, INC.  
INDEX**

**PART I FINANCIAL INFORMATION**

<u>Item 1. Financial Statements (Unaudited)</u>	3
<u>Balance Sheets as of June 30, 2008 and December 31, 2007</u>	3
<u>Statements of Operations for the Three and Six Months Ended June 30, 2008 and 2007</u>	4
<u>Statements of Cash Flows for the Six Months Ended June 30, 2008 and 2007</u>	5
<u>Notes to Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3. Quantitative and Qualitative Disclosure About Market Risk</u>	21
<u>Item 4. Controls and Procedures</u>	21

**PART II OTHER INFORMATION**

<u>Item 1. Legal Proceedings</u>	22
<u>Item 1A. Risk Factors</u>	22
<u>Item 2. Unregistered Sales of Equity and Use of Proceeds</u>	22
<u>Item 3. Defaults upon Senior Securities</u>	22
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	22
<u>Item 5. Other Information</u>	23
<u>Item 6. Exhibits</u>	23
<u>Signatures</u>	24
<u>EXHIBIT 3.2</u>	
<u>EXHIBIT 10.4</u>	
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ENOVA SYSTEMS, INC.  
BALANCE SHEETS**

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 10,963,000	\$ 10,485,000
Short term investment	2,000,000	
Accounts receivable, net	4,088,000	4,256,000
Inventories and supplies, net	6,755,000	3,565,000
Prepaid expenses and other current assets	301,000	457,000
Total current assets	24,107,000	18,763,000
Property and equipment, net	2,029,000	870,000
Investment in non-consolidated joint venture	1,411,000	1,470,000
Intangible assets, net	68,000	70,000
Total assets	\$ 27,615,000	\$ 21,173,000
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,649,000	\$ 1,877,000
Deferred revenues	34,000	101,000
Accrued payroll and related obligations	316,000	680,000
Other accrued expenses	2,353,000	2,063,000
Current portion of notes payable	97,000	95,000
Total current liabilities	4,449,000	4,816,000
Accrued interest payable	933,000	874,000
Notes payable, net of current portion	1,277,000	1,306,000
Total liabilities	6,659,000	6,996,000
Stockholders equity:		
Series A convertible preferred stock no par value, 30,000,000 shares authorized; 2,652,412 issued and outstanding; liquidating preference between \$1.25 and \$0.60 per share as of June 30, 2008 and December 31, 2007	1,679,000	1,679,000
Series B convertible preferred stock no par value, 5,000,000 shares authorized; 546,166 shares issued and outstanding; liquidating preference at \$2 per share as of June 30, 2008 and December 31, 2007	1,094,000	1,094,000
Common Stock no par value, 750,000,000 shares authorized; 20,623,774 and 17,172,631 shares issued and outstanding as of June 30, 2008 and December 31, 2007, respectively	134,360,000	121,970,000

Edgar Filing: ENOVA SYSTEMS INC - Form 10-Q

Common stock subscribed	42,000	30,000
Stock notes receivable for the sale of preferred stock	(1,149,000)	(1,149,000)
Additional paid-in capital	7,322,000	7,322,000
Accumulated deficit	(122,392,000)	(116,769,000)
Total stockholders' equity	20,956,000	14,177,000
Total liabilities and stockholders' equity	\$ 27,615,000	\$ 21,173,000

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

3

---

Table of Contents

**ENOVA SYSTEMS, INC.**  
**STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenues	\$ 3,370,000	\$ 1,059,000	\$ 5,648,000	\$ 2,602,000
Cost of revenues	3,736,000	1,794,000	6,178,000	3,333,000
Gross profit (loss)	(366,000)	(735,000)	(530,000)	(731,000)
Operating expenses				
Research and development	712,000	616,000	1,340,000	865,000
Selling, general & administrative	1,935,000	1,287,000	3,849,000	2,305,000
Total operating expenses	2,647,000	1,903,000	5,189,000	3,170,000
Gross operating loss	(3,013,000)	(2,638,000)	(5,719,000)	(3,901,000)
Other income and (expense)				
Interest and financing fees, net	69,000	65,000	154,000	176,000
Equity in losses of non-consolidated joint venture	(6,000)	(29,000)	(58,000)	(70,000)
Total other income, net	63,000	36,000	96,000	106,000
Net loss	\$ (2,950,000)	\$ (2,602,000)	\$ (5,623,000)	\$ (3,795,000)
Basic and diluted loss per share	\$ (0.15)	\$ (0.18)	\$ (0.30)	\$ (0.26)
Weighted average number of shares outstanding	20,054,000	14,837,000	18,623,000	14,837,000

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

**Table of Contents**

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

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>
Cash flows from operating activities:		
Net loss	\$ (5,623,000)	\$ (3,795,000)
Adjustments to reconcile net loss to net cash used in operating activities		
Bad Debt Expense	70,000	
Depreciation and amortization	261,000	147,000
(Gain) on asset disposal, net	(6,000)	
Equity in losses of non-consolidated joint venture	58,000	70,000
Issuance of common stock for employee services	21,000	
Issuance of common stock for director services	84,000	72,000
Stock option expense	273,000	40,000
(Increase) decrease in:		
Accounts receivable	98,000	(876,000)
Inventory and supplies	(3,190,000)	(2,214,000)
Prepaid expenses and other current assets	156,000	462,000
Increase (decrease) in:		
Accounts payable	(228,000)	543,000
Deferred revenues	(67,000)	(166,000)
Accrued payroll and related expense	(364,000)	17,000
Accrued expenses	290,000	551,000
Accrued interest payable	59,000	68,000
Net cash used in operating activities	(8,108,000)	(5,081,000)
Cash flows from investing activities:		
Purchases of short-term investments	(2,000,000)	
Maturities of short-term investments		5,000,000
Purchases of property and equipment	(1,411,000)	(139,000)
Net cash provided by (used) in investing activities	(3,411,000)	4,861,000
Cash flows from financing activities:		
Payment on notes payable and capital lease obligations	(27,000)	(14,000)
Legal and registration fees from the sale of common stock	(464,000)	
Cash proceeds from the sale of common stock	12,488,000	
Proceeds from the execution of stock options		192,000
Proceeds from repayment of stock note receivable		27,000
Net cash provided by financing activities	11,997,000	205,000

Edgar Filing: ENOVA SYSTEMS INC - Form 10-Q

Net increase (decrease) in cash and cash equivalents	478,000	(15,000)
Cash and cash equivalents, beginning of period	10,485,000	5,612,000
Cash and cash equivalents, end of period	\$ 10,963,000	\$ 5,597,000

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

5

---



**Table of Contents**

**ENOVA SYSTEMS, INC.  
NOTES TO FINANCIAL STATEMENTS  
(Unaudited)  
Six Months ended June 30, 2008 and 2007**

**1. Description of the Company and its Business**

Enova Systems, Inc. ( Enova 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**

**Interim Financial Information**

The financial information as of and for the six months ended June 30, 2008 and 2007 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 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 condensed interim financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2007, which are included in the Company s Annual Report on Form 10-K for the year then ended.

**Reclassifications**

Certain reclassifications have been made to the prior period financial statements to conform to the current quarter presentation.

**Fair Value of Financial Instruments**

The carrying amount of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, short term investments and accrued expenses, approximate fair value due to the short maturity of these instruments. The carrying value of all other financial instruments is representative of their fair values. The Company s short and long term debt may be less than the carrying value since there is no readily ascertainable market for the debt given the financial position of the Company.

**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.

**Table of Contents**

*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 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.

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, the Company applies the principles of Issue 00-21 to multiple element agreements.

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 under contract work-in-progress. 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.

**Table of Contents****Stock Based Compensation**

The Company calculates stock-based compensation expense in accordance with SFAS No. 123 revised,

Share-Based Payment ( SFAS 123(R) ). This pronouncement requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options to be based on estimated fair values.

**Use of Estimates**

The preparation of financial statements in conformity with 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.

**3. Inventory**

Inventory is comprised of the following:

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Raw Materials	\$ 5,985,000	\$ 3,037,000
Work In Progress	832,000	489,000
Finished Goods	38,000	139,000
Reserve for Obsolescence	(100,000)	(100,000)
<b>Total</b>	<b>\$ 6,755,000</b>	<b>\$ 3,565,000</b>

**4. Other Accrued Expenses**

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Accrued Inventory Received	\$ 1,204,000	\$ 351,000
Accrued Professional Services	351,000	890,000
Accrued Warranty	788,000	734,000
Other Accrued Expenses	10,000	10,000
<b>Total</b>	<b>\$ 2,353,000</b>	<b>\$ 2,063,000</b>

**Table of Contents****5. Notes Payable, Long-Term Debt and Other Financing**

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

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Secured note payable to Credit Managers Association of California, bearing interest at prime plus 3% (8.00% at June 30, 2008) 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 36 equal monthly installments of principal and interest through October 1, 2009	45,000	59,000
Secured note payable to a financial institution in the original amount of \$35,000, bearing interest at 10.45%, payable in 30 equal monthly installments of principal and interest through November 1, 2009	20,000	27,000
Secured note payable to a 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	31,000	37,000
	1,374,000	1,401,000
Less current portion	(97,000)	(95,000)
<b>Long-term portion</b>	<b>\$ 1,277,000</b>	<b>\$ 1,306,000</b>

*Revolving Credit Agreement*

In October 2007, the Company entered into a secured revolving credit facility with a financial institution (the Credit Agreement ) for \$2,000,000. The Credit Agreement is secured by a \$2,000,000 certificate of deposit. The interest rate is the certificate of deposit rate plus 1.25% with interest payable monthly and the principal due at maturity. The Credit Agreement expires on June 30, 2009. As of the six months ended June 30, 2008, the Company had \$1,800,000 available under the terms of the Credit Agreement as the financial institution has issued a \$200,000 irrevocable letter of credit in favor of Sunshine Distribution LP ( Landlord ), with respect to the lease of the Company s new corporate headquarters at 1560 West 190th Street, Torrance, California.

**6. Shareholders Equity**

On April 3, 2008, the Company sold 2,131,274 shares of common stock at 195 pence sterling per share (approximately US\$3.91 per share) to certain eligible offshore investors. The Company received approximately 4,200,000 pounds sterling (approximately US\$8,300,000) in gross proceeds from the offering. The placement agent earned a 5% selling commission, resulting in proceeds to Enova before offering expenses of approximately 3,990,000 pounds sterling (approximately \$7,784,000).

On May 1, 2008, the Company sold 1,273,700 shares of common stock for \$3.91 per share to certain accredited investors, resulting in gross proceeds of approximately \$4,980,000. The placement agent earned a selling commission of (i) a cash payment of approximately \$249,000 and (ii) 25,474 shares of common stock, in addition to reimbursement of expenses. After placement fees and offering expenses, the Company received net proceeds of approximately \$4,704,000. The Company granted the investors certain resale registration rights. In accordance with those rights, the Company filed a Registration Statement on Form S-3 (333-151502), covering the resale of 1,299,174

shares, that the Securities and Exchange Commission declared effective on June 17, 2008.

**Table of Contents**

Directors receive quarterly compensation for Board meeting attendance at a flat rate of \$4,000 in cash and \$6,000 in common stock valued at the closing price on the last business day of the quarter in which the meeting is held. Additionally, the Chairman of the Audit Committee receives \$10,000 and other members of the Audit Committee receive \$5,000 payable at the commencement of each year so long as the individual was on the Audit Committee before the filing of our Annual Report on Form 10-K for the prior fiscal year. Directors are also reimbursed for out-of-pocket expenses incurred in connection with attending Board and committee meetings. At June 30, 2008 and December 31, 2007, the Company was committed to issue 10,017 and 6,250 shares of common stock, respectively, to its Directors. The value of this common stock subscribed at June 30, 2008 and December 31, 2007 was \$42,000 and \$30,000, respectively and represents compensation to its Directors.

**7. Related Party Transactions**

The son and daughter-in-law of a Director on the Board of Directors own a website consulting firm that provides website design and tradeshow support services to the Company. During the six and three months ended June 30, 2008, the Company paid consulting fees and expenses to this firm in the amount of approximately \$93,000 and \$44,000, respectively. There was no outstanding payable balance owed to this firm on June 30, 2008.

**8. Stock Based Compensations Plans***Stock Option Program Description*

For the year ended December 31, 2007, the Company had one equity compensation plan, the 2006 Equity Compensation Plan (the 2006 Plan). The 1996 Stock Option 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 2006 Plan has a total of 3,000,000 shares reserved for issuance, of which a total of 631,000 options have been granted and are outstanding as of June 30, 2008. All stock options have between five and ten year terms and generally vest and become fully exercisable from one to three years from the date of grant. As of December 31, 2007, the Company had 329,000 options outstanding which were comprised of issuances from both the 1996 Plan and the 2006 Plan of 114,000 and 215,000, respectively.

*Quarter ended June 30, 2008*

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 \$184,000 for the six months ended June 30, 2008, 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:

	<b>June 30, 2008</b>	<b>June 30, 2007</b>
Income from continuing operations before income taxes	\$273,000	\$40,000
Income from continuing operations after income taxes	\$273,000	\$40,000
Cash flows from operations	\$273,000	\$40,000
Cash flows from financing activities	\$	\$
Basic and Diluted EPS	\$	\$

**Table of Contents**

As of June 30, 2008, the total compensation cost related to non-vested awards not yet recognized is \$1,159,000. The weighted average period over which the future compensation cost is expected to be recognized is 30 months.

	<b>Aggregate Plan Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Contractual Term in Years</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at December 31, 2007	329,000	\$ 4.23	5.85	\$ 85,000
Granted	420,000	\$ 3.82	9.74	\$ 154,000
Exercised		\$		\$
Forfeited	(4,000)	\$ 4.10		\$
Outstanding at June 30, 2008	745,000	\$ 4.00	7.67	\$ 173,000
Exercisable at June 30, 2008	303,000	\$ 4.20	5.64	\$ 27,000

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 second quarter of fiscal 2008 or \$4.19 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 June 30, 2008. This amount will change based on the fair market value of the Company's stock. The exercise prices of the options outstanding at June 30, 2008 ranged from \$3.81 to \$4.95. The exercise prices of the options outstanding at December 31, 2007 ranged from \$4.10 to \$4.95. Options exercisable were 303,000 and 204,000 at June 30, 2008 and December 31, 2007, respectively. The Company's policy is to issue shares from its authorized shares upon the exercise of stock options.

**9. Supplemental Cash Flow Information**

The Statement of Cash Flows for the six months ended June 30, 2008 and June 30, 2007, does not include under the caption "cash flows from financing activities" interest paid of \$1,000 and \$3,000, respectively.

**10. Recent Accounting Pronouncements**

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" (SFAS 141R) which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations the Company engages in will be recorded and disclosed following existing GAAP until January 1, 2009. The Company does not expect SFAS 141R will have an impact on its financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions the Company consummates after the effective date. The Company is evaluating the impact of this standard and currently does not expect it to have a significant impact on its financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" (SFAS 160). SFAS 160 introduces significant changes in the accounting and reporting for business acquisitions and noncontrolling interest (NCI) in a subsidiary. SFAS 160 also changes the accounting for and reporting for the deconsolidation of a subsidiary. Companies are required to adopt the new standard for fiscal years beginning after January 1, 2009. The Company is evaluating the impact of this standard and currently does not expect it to have a significant impact on its financial position, results of operations or cash flows.



In February 2008, The FASB issued FSP No. 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions ( FSP No. 140-3 ). FSP No. 140-3 clarifies repurchase financing, which is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty), that is entered

**Table of Contents**

into contemporaneously with, or in contemplation of, the initial transfer. FSP No. 140-3 is effective for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. The Company is evaluating the impact of this standard and currently does not expect the adoption of FSP No. 140-3 to have a significant impact on its financial position, cash flows and results of operations.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements. The Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. The provisions of SFAS No. 157 were to be effective for fiscal years beginning after November 15, 2007. On February 6, 2008, the FASB agreed to defer the effective date of SFAS No. 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Effective January 1, 2008, the Company adopted SFAS No. 157 except as it applies to those nonfinancial assets and nonfinancial liabilities. The adoption of SFAS No. 157 did not have significant impact on its financial position, cash flows and results of operations.

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 permits entities to measure many financial instruments and certain other items at fair value. Effective January 1, 2008, the Company adopted SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115. SFAS No. 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement of certain financial assets and liabilities under an instrument-by-instrument election. Subsequent measurements for the financial assets and liabilities an entity elects to fair value will be recognized in the results of operations. SFAS No. 159 also establishes additional disclosure requirements. The Company did not elect the fair value option under SFAS No. 159 for any of its financial assets or liabilities upon adoption. The adoption of SFAS No. 159 did not have a significant impact on its financial position, cash flows and results of operations.

In March 2008, the FASB issued SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( SFAS 161 ). SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. Companies are required to adopt the new standard for be effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company does not expect the adoption of SFAS 161 to have a significant impact on its financial position, results of operations or cash flows.

In June 2007 the FASB ratified EITF No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities ( EITF 07-3 ) which requires non-refundable advance payments for goods and services to be used in future research and development activities to be recorded as an asset and the payments to be expensed when the research and development activities are performed. EITF 07-3 is effective for fiscal years beginning after December 15, 2007. Effective January 1, 2008, the Company adopted EITF 07-3. The adoption of EITF 07-3 did not have a significant impact on its financial position, results of operations or cash flows.

In April 2008, the FASB issued FASB Staff Position ( FSP ) No. FAS 142-3, Determination of the Useful Life of Intangible Assets, ( FSP 142-3 ). The intent of this FSP is to improve consistency between the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS No. 142 ), and the period of expected cash flows used to measure the fair value of the intangible asset under SFAS No. 141R. FSP No. 142-3 will require that the determination of the useful life of intangible assets acquired after the effective date of this FSP shall include assumptions regarding renewal or extension, regardless of whether such arrangements have explicit renewal or extension provisions, based on an entity s historical experience in renewing or extending such arrangements. In addition, FSP No. 142-3 requires expanded disclosures regarding intangible assets existing as of each reporting period. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. The Company does not expect the adoption of FSP 142-3 to have a significant impact on its financial position, results of operations or cash flows.

In May 2008, the FASB issued Financial Accounting Standard (FAS) No. 162, The Hierarchy of Generally Accepted Accounting Principles. The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are prepared in conformance with generally accepted accounting principles. Unlike Statement on Auditing Standards (SAS) No. 69,

The Meaning of Present in Conformity With GAAP, FAS No. 162 is directed to the entity rather than the auditor. The statement is effective 60 days following the SEC's approval of the Public Company

**Table of Contents**

Accounting Oversight Board (PCAOB) amendments to AU Section 411, The Meaning of Present Fairly in Conformity with GAAP, and is not expected to have any impact on the Company's results of operations, financial condition or liquidity.

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

*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 need, 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 our Annual Report on Form 10-K for the year ended December 31, 2007.*

*We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and potentially inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. You should bear this in mind as you consider forward-looking statements. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise.*

*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, 2007.*

**Overview**

The Company believes it is a leader in the development and production of proprietary, commercial digital power management systems for heavy transportation applications such as trucks and buses. Power management systems control and monitor electric power in a transportation 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 the Company'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.

**Table of Contents**

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 these 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.

The Company'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 January 2008, we announced a production contract with Smith Electric Vehicles, a division of The Tanfield Group Plc. At the time, based upon the contract, the Company expected to supply in excess of 1,000 units in 2008 and as many as 3,000 in 2009 to Smith Electric Vehicles. In July 2008, however, Tanfield announced that although demand for electric vehicles has remained, it now expects lower forecast sales of electric vehicles. To date, Enova has delivered 450 drive systems to Tanfield, consisting of 306 units in 2007 and 144 units in 2008. Due to Tanfield's realigned growth strategy, Enova now expects fewer orders of drive systems from Tanfield in 2008 and 2009. There are no assurances that purchase orders will be realized from Tanfield and therefore revenues may decline in comparison to the prior fiscal 2007 year.

In May 2008, we expanded an existing customer relationship by entering into a long term supply agreement with IC Corporation, a division of Navistar. Pursuant to the agreement, Navistar has agreed to purchase Post-Transmission Hybrid drive systems equipment and services exclusively from Enova, and Enova has agreed to supply drive systems equipment and services to Navistar. In addition, Enova has agreed to not sell drive systems equipment and services to any other party other than Navistar into the North American school and commercial bus market, unless expressly authorized by Navistar. The initial term of the agreement terminates on February 28, 2011 and may be extended for two additional terms of 12 months upon agreement by Enova and Navistar. The agreement may be terminated by Navistar for any reason with 120 days prior notice to Enova by Navistar. If certain Navistar purchasing goals are not achieved by Navistar, Enova's obligation to exclusively supply drive systems to Navistar in the North American school and commercial bus market may be terminated. In addition, if Enova is unable to supply Navistar's requirements pursuant to the Agreement, then Navistar's obligation to exclusively purchase from Enova may be terminated. Although the supply agreement provides forecasted volumes, there is no assurance these goals will be met. The revenue we receive under the agreement will depend upon the number of drive systems ordered.

During the second quarter, Enova management visited First Auto Works of China (FAW) research and development center and FAW's affiliate electronics manufacturer in China, to further develop the basis for a continued cooperation on hybrid transit buses, and potentially on other FAW vehicles. Enova has developed a customized, pre-transmission, solution for FAW. This system has been designed in parallel with FAW's development of a new transmission package, which they hope to aggressively market across Asia, and possibly export abroad. The designed in feature of our pre-transmission hybrid system indicates that Enova will continue to be heavily engaged with FAW in their efforts to market their hybrid solutions.

In the second quarter of 2008, The Company delivered additional prototype vehicles to our Asian-based OEM customer, who has, in turn, delivered them to two of their largest fleet customers. Enova has provided service training for these fleet owners, and continues to monitor the vehicles during their evaluation. We continue to mature this

relationship, as we believe it will develop into viable business relationships.

During the second quarter of 2008, Enova, along with HHI, evaluated the relationship to determine its future role for both companies. Although integral to our development and financial stability in prior years, Enova is now is more established in the market as a fully functional, self-sufficient entity. To meet the anticipated needs of our core customers, we have developed resources to supply our products to the medium and heavy duty truck and bus market segment.

**Table of Contents**

In February 2008, we announced a contract with Th!nk Global on the production of 1,000 Power Control Units in 2008. In the second quarter of 2008, Enova and Th!nk Global management convened in Torrance to discuss future pricing and other commercial terms. Subsequently, Enova determined this product was unlikely to be profitable under the negotiated conditions. Enova and Th!nk Global mutually agreed to support the relocation of this business to an alternative supplier selected by Th!nk Global. Th!nk Global has agreed to purchase certain production rights associated with the Power Control Unit.

In March 2008, the Company finalized its move into a 43,000 square foot facility located at 1560 W 190th Street, Torrance (the lease ). The Lease term commenced on November 1, 2007, and expires on January 1, 2013. Our expansion into a new facility was determined an essential part of our movement into a production stage. The Company also began planning for a certification and audit of its standards in accordance with the International Organization for Standardization ( ISO ). We believe the receipt of an independent ISO certification will allow the Company to supplement its existing product and service characteristics of quality, environmental friendliness, safety, reliability, efficiency and versatility.

During the second quarter of 2008, we continued to develop and produce electric and hybrid electric drive systems and components for FAW, International Truck and Engine (IC Corp), Hyundai Motor Car, the 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, and Navistar (International Truck and Engine, IC Corporation). We have been engaged to develop two different prototype transit buses for a new UK bus manufacturer. These vehicles will be delivered in the fourth quarter of 2008. 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. In the second quarter of 2008, we completed the commissioning of the drive systems in 8 maintenance locomotives for the Light Transit Authority of Singapore, Malaysia. Enova supplied drive motors, chargers, and battery control units to Tomoe, who, in conjunction with the Hitachi Corporation, completed the testing and delivery of these locomotives. Enova and Tomoe will bid on additional orders later this year. There are no assurances purchase orders will be realized from this bidding.

Enova continues 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 various parties may result in production contracts during 2008 and beyond, there are no assurances that such additional agreements will be realized.

Enova has incurred significant operating losses in the past. As of June 30, 2008, we had an accumulated deficit of approximately \$122.4 million. We expect to incur additional operating losses until we achieve a level of product sales sufficient to cover our operating and other expenses.

**Critical Accounting Policies**

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, 2007

The following represents a summary of our critical accounting policies, defined as those policies that we believe: (a) are the most important to the portrayal of our financial condition and results of operations and (b) involve inherently uncertain issues which require management's most difficult, subjective or complex judgments.

**Cash and cash equivalents** Cash consists of currency held at reputable financial institutions.

**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





**Table of Contents**

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.

***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.

***Stock-based Compensation*** The Company calculates stock-based compensation expense in accordance with SFAS No. 123 revised, Share-Based Payment ( SFAS 123 (R) ). This pronouncement requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options to be based on estimated fair values. The Company adopted SFAS 123 (R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the beginning of the Company's 2006 fiscal year. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ) related to SFAS 123 (R). The Company applied the provisions of SAB 107 in adopting SFAS 123 (R).

***Revenue 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.

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.

**Table of Contents****RESULTS OF OPERATIONS**

Three and Six Months Ended June 30, 2008 compared to Three and Six Months Ended June 30, 2007  
*Second Quarter of Fiscal 2008 vs. Second Quarter of Fiscal 2007*

	Three Months Ended June 30,			As a % of Revenues June 30,	
	2008	2007	% Change	2008	2007
Revenues	\$ 3,370,000	\$ 1,059,000	218%	100%	100%
Cost of revenues	3,736,000	1,794,000	108%	111%	169%
Gross profit (loss)	(366,000)	(735,000)	-50%	-11%	-69%
Operating expenses					
Research and development	712,000	616,000	16%	21%	58%
Selling, general & administrative	1,935,000	1,287,000	50%	57%	122%
Total operating expenses	2,647,000	1,903,000	39%	79%	180%
Gross operating loss	(3,013,000)	(2,638,000)	14%	-89%	-249%
Other income and (expense)					
Interest and financing fees, net	69,000	65,000	6%	2%	6%
Equity in losses of non-consolidated joint venture	(6,000)	(29,000)	-79%	0%	-3%
Total other income, net	63,000	36,000	75%	2%	3%
Net loss	\$ (2,950,000)	\$ (2,602,000)	13%	-88%	-246%

*First Six Months of Fiscal 2008 vs. First Six Months of Fiscal 2007*

	Six Months Ended June 30,			As a % of Revenues June 30,	
	2008	2007	% Change	2008	2007
Revenues	\$ 5,648,000	\$ 2,602,000	117%	100%	100%
Cost of revenues	6,178,000	3,333,000	85%	109%	128%
Gross profit (loss)	(530,000)	(731,000)	-27%	-9%	-28%
Operating expenses					
Research and development	1,340,000	865,000	55%	24%	33%
Selling, general & administrative	3,849,000	2,305,000	67%	68%	89%
Total operating expenses	5,189,000	3,170,000	64%	92%	122%
Gross operating loss	(5,719,000)	(3,901,000)	47%	-101%	-150%

Other income and (expense)					
Interest and financing fees, net	154,000	176,000	-13%	3%	7%
Equity in losses of non-consolidated joint venture	(58,000)	(70,000)	-17%	-1%	-3%
Total other income, net	96,000	106,000	-9%	2%	4%
Net loss	(5,623,000)	\$ (3,795,000)	48%	-100%	-146%

*The sum of the amounts and percentages may not equal the totals for the period due to the effects of rounding.*

Computations of percentage change period over period are based upon our results, as rounded and presented herein.

**Revenue.** Revenues increased by \$3,046,000 or 117% for the six months ended June 30, 2008 to \$5,648,000 as compared to \$2,602,000 for the corresponding period in 2007. Production sales for the six months ended June 30, 2008 increased to \$5,648,000 from \$2,602,000 in the same period in 2007. Revenues for the three months ended June 30, 2008 increased to \$3,370,000 or 218% from \$1,059,000 for the corresponding period in 2007. Our research and development revenues for the six and three months ended June 30, 2008 and June 30, 2007 were zero, although we may realize research and development revenues in the future. The increase in revenues for both periods was attributed entirely to our increase in production sales. Furthermore, revenues were derived from contracts with The Tanfield Group Plc (Tanfield), Th!nk Global, First Auto Works of China (FAW), IC Corporation, and the Hawaii Center for Advanced Transportation Technologies (HCATT). Revenue associated with Th!nk Global's production rights as referenced in the Overview above were approximately \$300,000. We continue to improve the awareness of our product and service

**Table of Contents**

offerings with clients in part because of our past research and development efforts as well as our production efforts. However, based upon the order cancellation from Th!nk Global and a change in Tanfield's growth strategy discussed in the Overview above, our quarterly revenues for the remainder of 2008 may decline. Although we have seen indications for future production growth, there can be no assurances there will be continuing demand for our products and services.

**Cost of Revenues.** Cost of revenues consists of component and material, direct labor costs, integration costs and overhead related to manufacturing our products. Cost of revenues for the six and three months ended June 30, 2008 increased to \$6,178,000 or 85% and \$3,736,000 or 108%, respectively from \$3,333,000 and \$1,794,000, respectively for the same periods in 2007. Cost of revenues for the six and three months ended June 30, 2008 and the same period in 2007 were solely attributed to production cost of revenues. This is primarily attributable to the increase in sales for the named periods and increases in integration support costs as well as the continued identification of manufacturing efficiencies for incorporation in production runs.

**Gross Margin.** As a percentage of total net revenues, gross margins improved, for the six months ended June 30, 2008, to a negative 9% from a negative 28% for the same period in 2007. Gross margins also improved for the three months ended June 30, 2008 to a negative 11% from a negative 69% for the same period in 2007. Gross loss for the six months ended June 30, 2008 decreased to \$530,000 from a gross loss of \$731,000 for the same period in 2007. Gross loss for the three months ended June 30, 2008 also decreased to \$366,000 from a gross loss of \$735,000 for the same period in 2007. We have taken, and continue to take measures in maturing our supply chain. This includes the continued refinement of our production line resources in light of our new assembly line layout. We continue to take benefits from the maturity of these initiatives although we may experience a decline in gross margin.

**Research and Development.** Internal research, development and engineering expenses increased \$475,000 or 55% in the six months ended June 30, 2008 to \$1,340,000 from \$865,000 for the same period in 2007. These expenses also increased by \$96,000 or 16% for the three months ended June 30, 2008 to \$712,000 from \$616,000. As a percentage of revenues for the six and three months ended in 2008 and 2007, research and development decreased from 33% to 24% and 58% to 21%, respectively. The continued development of products such as our Panther Wireless Monitor and upgrade, Post-Transmission Parallel Hybrid Drive system, engine off capability, and enhancements to our diesel generator set accounted for an increase, year to date, in our internal research and development costs. We also continued to allocate necessary resources to the refinement and development of our parallel hybrid drive systems, upgraded proprietary control software, enhanced DC-DC converters, and advanced digital inverters as well as other power management firmware.

**Selling, General, and Administrative Expenses ( S, G & A ).** Selling, general and administrative expenses increased \$1,544,000 or 67% for the six months ended June 30, 2008 to \$3,849,000 from \$2,305,000 for the same period in 2007. These expenses also increased by \$648,000 or 50% for the three months ended June 30, 2008 to \$1,935,000 from \$1,287,000. S, G & A is comprised of activities in the executive, finance, purchasing, administrative engineering, field service, quality, and facility departments, including non-cash charges of depreciation and amortization. In the first six months of fiscal year 2008, S, G & A costs increased in comparison to the same period in 2007 due to the employment of additional human resources in the fields of engineering and administration, increases in legal and external auditing fees, rent and maintenance expenses, non-cash, stock-based compensation charges associated with option grants and common stock issuances, as well as the refinement of processes and controls in light of our new facility's layout. As a percentage of revenues for the six and three months ended in 2008 and 2007, S, G & A decreased from 89% to 68% and 122% to 57%, respectively. During the six months of 2008, we finalized the move into our new facility in Torrance, CA and experienced an increase in expenses associated with this move. In light of our new facility's 43,000 square foot size, we have incurred an increase in rent and maintenance expenses in comparison of the six and three month periods in 2008 to the six and three months periods in 2007. We also employed independent contractors in the fields of engineering to assist our existing engineering department as part of our continued efforts to support our current customers and to position the organization for potential growth in the first six months of 2008 compared to the first six months of 2007. The Company may continue to experience increases with respect to our standardization efforts associated with Section 404 of the Sarbanes-Oxley Act of 2002 and the International Organization for Standardization ( ISO ). The Company also incurred an increase in administrative,

marketing, and proxy solicitation fees associated with the annual shareholder s meeting. We also experienced an increase during the first six months of 2008 in comparison to the same period for 2007 in our legal fees resulting from the administration of securities issued in the third quarter of 2007. The Company also experienced increases in its sales and marketing expenditures, in particular travel expenses associated with current and prospective customer support initiatives and strategy sessions. Management has identified several cost reduction strategies in 2008 however, there are no assurances our selling, general, and administrative expenses will decrease in the future.

**Table of Contents**

**Interest and Financing Fees, Net.** Interest and financing fees income decreased by \$22,000 and increased by \$4,000 to \$154,000 and \$69,000 for the six and three months ended June 30, 2008 respectively, in comparison to the same period in 2007. This decrease continues to be a result of lower, average cash balances for the comparative periods in 2008 and 2007.

**Net Loss.** The Company realized a net loss increase of \$1,828,000 for the six months ended June 30, 2008 to \$5,623,000 from \$3,795,000 for the same period in 2007. Our net loss for the three months ended June 30, 2008 was \$2,950,000 or an increase of \$348,000 from \$2,602,000 for the same period in 2007. We continued to incur additional costs, specifically both in S, G & A and internal research and development associated with the maturity of our production stage. These additional costs have increased our net loss when compared to the comparable period in 2007.

**LIQUIDITY AND CAPITAL RESOURCES**

We have experienced cash flow shortages due to operating losses primarily attributable to research and development, marketing, selling, general, and administrative expenses, 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. The extent of our capital needs will phase out once we reach a breakeven volume in sales or developing and/or acquire the capability to manufacture and sell our products profitably. Our operations during the year ended December 31, 2007 and through the six months ended June 30, 2008 were financed by product sales and development contracts, as well as from working capital reserves. As of June 30, 2008, the Company had \$12,963,000 of cash and cash equivalents and short term investments.

We have a secured revolving credit facility from Union Bank of California for \$2,000,000. The credit facility expires on June 30, 2009. As of June 30, 2008, \$1,800,000 was available under the credit facility due to \$200,000 irrevocable letter of credit issued by Union bank in favor of our landlord with respect to the lease of the our new corporate headquarters. The credit facility is secured by a \$2,000,000 certificate of deposit. The interest rate is the certificate of deposit rate plus 1.25% with interest payable monthly and the principal due at maturity.

Net cash used in operating activities was \$8,108,000 for the six months ended June 30, 2008 compared to \$5,081,000 for the six months ended June 30, 2007. Cash used in operating activities the first six months of 2008 were affected mostly by the operating loss of \$5,623,000 and an increase in inventory and supplies of \$3,190,000 along with a net decrease in current liabilities of \$310,000. Non-cash items offset the aforementioned current asset and current liabilities by \$761,000 which includes expenses for stock-based compensation, depreciation and amortization, bad debt expense, equity losses of our non-consolidated joint venture, and issuance of common stock for director services. These charges do not reflect an actual cash outflow from the Company but are an estimate of the fair value of the services provided by employees and directors in exchange for stock option grants and common stock, respectively. We continued to increase marketing and development spending as well as administrative expenses necessary for potential expansion in anticipation of customer demand as well as corporate governance and regulatory compliance efforts.

Net cash used in investing activities was \$3,411,000 for the first six months of 2008 compared to net cash provided of \$4,861,000 in the first six months of 2007. Cash used in investing activities in the first six months of 2008 was attributed to leasehold improvements and fixed asset purchases associated with our move into a new facility and the purchase of a certificate of deposit used as security for the revolving credit facility of \$2,000,000 referenced above. In the same period for 2007, our certificate of deposit maturity, net of purchases of fixed assets, resulted in cash provided of \$4,861,000.

Net cash provided by financing activities totaled \$11,997,000 for the first six months of 2008, compared to net cash provided of \$205,000 for the first six months of 2007. During the first and second quarters of 2008, we raised capital through two placements of common stock. On April 3, 2008, we sold 2,131,274 shares of common stock at 195 pence sterling per share (approximately US\$3.91 per share) to certain eligible offshore investors. We received approximately 4,200,000 pounds sterling (approximately US\$8,300,000) in gross proceeds from the offering. The placement agent earned a 5% selling commission, resulting in proceeds to us before offering expenses of approximately 3,990,000 pounds sterling (approximately \$7,784,000). On May 1, 2008, we sold 1,273,700 shares of common stock for \$3.91 per share to certain accredited investors, resulting in gross proceeds of approximately

\$4,980,000. The placement agent earned a selling commission of (i) a cash payment of approximately \$249,000 and (ii) 25,474 shares of common stock, in addition to reimbursement of expenses. After placement fees and offering expenses, we received net proceeds of \$4,704,000. Both of these common stock offerings and sales also produced a related cash outflow of \$464,000 in the first six months of 2008 due to legal and regulatory administration fees.

**Table of Contents**

Inventory increased by \$3,190,000 when comparing the balances at June 30, 2008 and December 31, 2007. This represents a 89% increase in the inventory balance between the two periods. Management identified \$2,600,000 million of the increase in inventory and supplies were associated with Tanfield's anticipated growth. The Enova drive system design is suitable for different applications and vehicle producers. As a result, Enova believes it can mitigate any decline in Tanfield orders by redirecting inventory through sales and production with other customers. The residual increase of \$590,000 net of Tanfield inventory was attributed to support our anticipated sales order volume with other customers.

Prepaid expenses and other current assets decreased 34% by net \$156,000 at June 30, 2008 from the December 31, 2007 balance of \$457,000. In the first quarter of 2008, we recorded prepaid expenses of approximately \$270,000 associated with the April 3, 2008 sale of common stock that was completed during the second quarter of 2008. Deposits and insurance premiums of approximately \$98,000 offset the recognition of prepaid asset associated with the sale of common stock.

Fixed assets increased by \$1,159,000 or 133%, net of depreciation and write-offs, at June 30, 2008, when compared to the December 31, 2007 balance of \$870,000. In the first six months of 2008, we completed our move to a new facility and experienced an increase in leasehold improvements and purchases of fixed assets of \$1,159,000, net of depreciation and write-offs. We recognized \$261,000 worth of depreciation expense in the first six months of 2008.

Investment in our non-consolidated joint venture decreased by \$58,000 or 4% in the first six months of 2008 from a balance of \$1,470,000 at December 31, 2007, reflecting the pro-rata share of losses attributable to our forty percent investment interest in the Hyundai-Enova Innovative Technology Center (ITC). For the first six months of 2008, the ITC generated a net loss of approximately \$145,000 resulting in a charge to us of \$58,000 utilizing the equity method of accounting for our interest in the ITC. Enova, along with HHI, are evaluating the relationship to determine its future role for both companies.

Accounts payable decreased in the second quarter of 2008 by \$228,000 or 12% to \$1,649,000 from \$1,877,000 at December 31, 2007. This decrease is attributable to a sequential, first quarter of 2008 to second quarter of 2008, improvement in days payables outstanding.

Deferred revenues decreased at June 30, 2008 by \$67,000 or 66%, when comparing to the December 31, 2007 balance of \$101,000. This difference represents the realization of revenue that had been deferred in December 2007, predominantly associated with our contract with the State of Hawaii.

Accrued payroll and related expense decreased by \$364,000 or 54% at June 30, 2008, when compared to the balance reported at December 31, 2007. As of December 31, 2007, a performance bonus accrual of approximately \$200,000 was disbursed in 2008. No performance bonus obligations existed as of June 30, 2008 and therefore the decrease was a result of the absence of a performance bonus for that period. In addition, payroll was disbursed near the period end date of June 30, 2008 and as a result, there was an accrual for a shorter period when compared to the December 31, 2007 balance.

Other accrued expenses increased by \$290,000 or 14% at June 30, 2008 from the balance of \$2,063,000 at December 31, 2007, primarily due to a decrease in the accrual of professional services by \$562,000, as well as increases in accruals for inventory receipts of \$786,000. Furthermore, we increased our warranty accrual in proportion to increases in sales by \$54,000.

Accrued interest payable increased to \$59,000 or 7% for the second quarter of 2008, an increase of 7% from the balance of \$874,000 at December 31, 2007. The increase is due to interest related to our debt instruments, primarily the secured note payable to the Credit Managers Association of California of \$1,238,000.

Our ongoing operations and anticipated growth will require us to continue making investments in human resources, regulatory compliance, as well as sales and marketing efforts. We anticipate that our current cash will be adequate to meet our working capital and capital expenditure needs for at least the next 12 months. If we require additional capital resources to grow our company, we may seek to sell more equity securities. The sale of equity securities could result in dilution to our stockholders. We may not be able to obtain financing arrangements in amounts or on terms acceptable to us in the future. In the event we are unable to obtain additional financing when needed, we may be compelled to delay or curtail our plans to develop our business, which could have a material adverse effect on our operations, market position and competitiveness.





**Table of Contents**

**Recent Accounting Pronouncements**

Information regarding recent accounting pronouncements is contained in Note 10 to the Financial Statements for the six months ended June 30, 2008.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements.

**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 second quarter of fiscal 2008, the Company's management, including its Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended (the Exchange Act). Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as of June 30, 2008 due to the material weakness identified as part of our annual report on internal control over financial reporting as disclosed in the Annual Report on Form 10-K for the 12 months ended December 31, 2007 and summarized below.

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2007, management's assessment identified a material weakness in our inventory process due to ineffective controls over the inventory pricing, tracking, and reserve analysis. This control deficiency resulted in an audit adjustment to our 2007 financial statements and could result in a misstatement to cost of sales that would result in a material misstatement to the annual and interim financial statements that may not be prevented or detected. Our independent registered public accounting firm, PMB Helin Donovan, concluded this deficiency constituted a material weakness in our internal controls. Our management also determined this deficiency constituted a material weakness that impacted our disclosure controls and procedures in our Annual Report on Form 10-K for the year ended December 31, 2007 and continued through the period covered by this Form 10-Q.

**Remedial Actions and Changes in Internal Control**

As previously disclosed in our Form 10-K for the year ended December 31, 2007, we have developed and are implementing remediation plans to address the material weakness identified above and otherwise enhance our internal control over financial reporting. During the quarter ended June 30, 2008 specifically, we began the planning for an independent certification and audit of standards in accordance with the International Organization for Standardization (ISO). Otherwise, there have not been any changes in our internal control over financial reporting as of the quarter ended June 30, 2008 that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**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. During the quarter ended June 30, 2008, we were not involved in any material legal proceedings.

**Item 1A. Risk Factors**

Other than as reflected below, 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, 2007.

***Because we depend upon sales to a limited number of customers, our revenues will be reduced if we lose a major customer***

Our revenue is dependent on significant orders from a limited number of customers. We typically enter into supply agreements with major customers establishing product and price standards for future periods. Subsequent events may change the needs of the customer, requiring us to make corresponding adjustments. In fiscal year ended December 31, 2007, Tanfield accounted for 52% of our total revenues. Based upon public announcement by Tanfield in July 2008, we now expect fewer orders from Tanfield for the remainder of 2008 and 2009. We believe that revenues from major customers will continue to represent a significant portion of our revenues. In May 2008 we entered into a new supply agreement with Navistar Inc., which we expect will be our largest customer in the future. This customer concentration increases the risk of quarterly fluctuations in our revenues and operating results. The loss or reduction of business from one or a combination of our significant customers could adversely affect our revenues, financial condition and results of operations. Moreover, our success will depend in part upon our ability to obtain orders from new customers, as well as the financial condition and success of our customers and general economic conditions.

***We extend credit to our customers, which exposes us to credit risk***

Most of our outstanding accounts receivable are from a limited number of large customers. At June 30, 2008, the five highest outstanding accounts receivable balances totaled \$3,540,000 which represents 84% of our gross accounts receivable, with one customer accounting for \$1,672,000, representing 40% of our gross accounts receivable. If we fail to monitor and manage effectively the resulting credit risk and a material portion of our accounts receivable is not paid in a timely manner or becomes uncollectible, our business would be significantly harmed, and we could incur a significant loss associated with any outstanding accounts receivable.

**Item 2. Unregistered Sales of Equity and Use of Proceeds**

Not applicable.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

The Annual Meeting of Shareholders was held on May 22, 2008 in Torrance, California. At the Annual Meeting, the following matters were considered and voted upon:

**Proposal No. 1:** To elect eight directors to serve under the 2009 Annual Meeting of Shareholders and until their respective successors are elected and qualify.

**Table of Contents**

At the Annual Meeting, Bjorn Ahlstrom, Malcolm R. Currie, John J. Micek, Edwin O. Riddell, Michael E. Staran, and John R. Wallace were re-elected and Richard Davies and Roy S. Roberts were elected as directors by the votes indicated below:

<b>Director Nominee</b>	<b>Votes Cast For</b>	<b>Votes Against</b>
Bjorn Ahlstrom	10,711,049	884,270
Malcolm R. Currie	10,711,016	884,303
Richard Davies	10,710,959	884,360
John J. Micek	10,711,703	883,616
Edwin O. Riddell	10,646,961	948,358
Roy S. Roberts	10,710,580	884,739
Michael E. Staran	10,709,961	885,358
John R. Wallace	10,711,738	883,581

**Proposal No. 2:** To ratify the selection of PMB Helin Donovan, LLP as independent auditors for 2008.

At the Annual Meeting, our shareholders approved this proposal by the votes indicated below:

<b>Votes Cast For</b>	<b>Votes Against</b>	<b>Abstentions</b>	<b>Broker Non-Votes</b>
11,553,456	25,128	16,735	

**Item 5. Other Information**

None.

**Item 6. Exhibits**

a) Exhibits

- 3.1 Our Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of our Annual Report on Form 10-K for the fiscal year ending December 31, 2006, as filed on April 2, 2007)
- 3.2 Our Amended and Restated Bylaws (reflecting previously disclosed amendments on August 28 and December 4, 2007)\*
- 10.1 Placing Agreement entered into March 26, 2008 (incorporated by reference to Exhibit 10 of our Current Report on Form 8-K filed April 4, 2008)
- 10.2 Securities Purchase Agreement entered into April 23, 2008 (incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed April 24, 2008)
- 10.3 Registration Rights Agreement entered into April 23, 2008 (incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K filed April 24, 2008)
- 10.4 Supply Agreement with Navistar , Inc. entered into May 16, 2008\*#
- 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 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*

\* Filed herewith

# Portions of the exhibit have been omitted pursuant to a request for confidential treatment submitted to the Securities and Exchange Commission.

**Table of Contents**

**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.

ENOVA SYSTEMS, INC. (Registrant)

Date: August 14, 2008

By: /s/ Jarett Fenton  
Jarett Fenton, Chief Financial Officer

**Table of Contents**

**Exhibit Index**

**EXHIBITS**

- 3.1 Our Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of our Annual Report on Form 10-K for the fiscal year ending December 31, 2006, as filed on April 2, 2007)
- 3.2 Our Amended and Restated Bylaws (reflecting previously disclosed amendments on August 28 and December 4, 2007)\*
- 10.1 Placing Agreement entered into March 26, 2008 (incorporated by reference to Exhibit 10 of our Current Report on Form 8-K filed April 4, 2008)
- 10.2 Securities Purchase Agreement entered into April 23, 2008 (incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed April 24, 2008)
- 10.3 Registration Rights Agreement entered into April 23, 2008 (incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K filed April 24, 2008)
- 10.4 Supply Agreement with Navistar, Inc. entered into May 16, 2008\*#
- 31.1 Certification of the Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002\*
- 31.2 Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 32 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*

\* Filed herewith

# Portions of the exhibit have been omitted pursuant to a request for confidential treatment submitted to the Securities and Exchange Commission.