ENOVA SYSTEMS INC
Form 10-Q
May 10, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

(_x_)

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

For the Quarterly Period Ended March 31, 2006

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. 0-25184

ENOVA SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

CALIFORNIA

95-3056150

(State or other jurisdiction of

(IRS employer identification number)

incorporation or organization)

19850 South Magellan Drive Torrance, CA 90502

(Address of Principal Executive Offices and Zip Code)

Registrant s telephone number, including area code (310) 527-2800

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 (_X_) No (___)

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

As of May 10, 2006, there were 14,792,000 shares of Common Stock, no par value, 2,674,000 shares of Series A Preferred Stock, no par value, and 1,217,000 shares of Series B Preferred Stock, no par value, outstanding.

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ENOVA SYSTEMS, INC.

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

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ENOVA SYSTEMS, INC.
BALANCE SHEETS

ASSETS

	As of March 31, 2006 (unaudited)	As of December 31, 2005
Current assets		
Cash and cash equivalents	$ 4,826,000	$ 16,187,000
Short term investments	10,000,000	--
Accounts receivable, net	774,000	2,173,000
Inventories and supplies, net	1,014,000	1,016,000
Prepaid expenses and other current assets	274,000	182,000
Total current assets	16,888,000	19,558,000
Property and equipment, net	597,000	576,000
Equity method investment	1,623,000	1,649,000
Other assets	163,000	190,000
Total assets	**$ 19,271,000**	**$ 21,973,000**

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

Current liabilities		
Accounts payable	$ 160,000	$ 1,396,000
Accrued payroll and related expense	207,000	195,000
Other accrued expenses	199,000	302,000
Current portion of notes payable	40,000	42,000
Total current liabilities	606,000	1,935,000
Accrued interest payable	634,000	1,113,000
Notes payable, net of current portion	1,238,000	2,321,000

Total liabilities	$	2,478,000	$ 5,369,000
Commitments and contingencies			
Stockholders' equity (deficit)			
Series A convertible preferred stock - no par value 30,000,000 shares authorized 2,674,000 and 2,674,000 shares issued and outstanding Liquidating preference at $0.60 per share, aggregating $1,604,000	$	1,679,000	$ 1,679,000
Series B convertible preferred stock - no par value 5,000,000 shares authorized			

1,217,000 and 1,217,000 shares issued and outstanding				
Liquidating preference at $2 per share, aggregating $2,434,000		2,434,000		2,434,000
Common Stock, no par value				
750,000,000 shares authorized				
14,783,000 shares issued and outstanding		109,323,000		109,323,000
Common stock subscribed		60,000		30,000
Stock notes receivable		(1,176,000)		(1,176,000)
Additional paid-in capital		6,914,000		6,900,000
Accumulated deficit		(102,441,000)		(102,586,000)
Total stockholders' equity		16,793,000		16,604,000
Total liabilities and stockholders' equity	**$**	**19,271,000**	**$**	**21,973,000**

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

ENOVA SYSTEMS, INC.
STATEMENTS OF OPERATIONS (Unaudited)
For the Three Months Ended March 31,

	2006	2005
Net revenues		
Research and development contracts	$ 45,000	$ 200,000
Production	264,000	492,000
Total net revenues	309,000	692,000
Cost of revenues		
Research and development contracts	170,000	119,000
Production	290,000	451,000
Total cost of revenues	460,000	570,000
Gross profit (loss)	(151,000)	122,000
Operating expenses		
Research and development	325,000	217,000
Selling, general and administrative	924,000	608,000
Loss from operations	(1,400,000)	(703,000)
Other income (expense)		
Interest and other income (expense), net	179,000	(69,000)
Equity in losses of equity method investee	(26,000)	(40,000)
Debt extinguishment	920,000	-
Interest extinguishment	472,000	-
Total other income (expense)	1,545,000	(109,000)
Net income (loss)	**$ 145,000**	**$ (812,000)**
Basic earnings (loss) per share	**$ 0.01**	**$ (0.09)**
Diluted earnings (loss) per share	**$ 0.01**	**$ (0.09)**
Basic weighted-average number of shares outstanding	**14,783,000**	**9,238,000**
Diluted weighted-average number of		

shares outstanding	**15,141,000**	**9,238,000**

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

ENOVA SYSTEMS, INC.
STATEMENTS OF CASH FLOWS (Unaudited)
For the Three Months Ended March 31,

	2006	2005
Cash flows from operating activities		
Net income / (loss)	$ 145,000	$ (812,000)
Adjustments to reconcile net income/(loss)		
to net cash used in operating activities		
Debt extinguishment	(920,000)	-
Interest extinguishment	(472,000)	-
Bad Debt Expense	-	23,000
Depreciation and amortization	90,000	72,000
Equity in losses of equity method investee	26,000	40,000
Issuance of subscribed common stock for services	30,000	28,000
Stock based compensation expense	14,000	
(Increase) decrease in		
Accounts receivable	1,399,000	(170,000)
Inventory and supplies	2,000	(135,000)
Prepaid expenses and other current assets	(92,000)	(60,000)
Increase (decrease) in		
Accounts payable	(1,236,000)	226,000
Accrued expenses	(91,000)	61,000
Deferred revenues	-	(118,000)
Accrued interest payable	(7,000)	73,000
Net cash used in operating activities	(1,112,000)	(772,000)
Cash flows from investing activities		
Purchase of short term investments	$ (10,000,000)	$ -
Purchases of property and equipment	(84,000)	(46,000)
Net cash used in investing activities	(10,084,000)	(46,000)
Cash flows from financing activities		
Net payments on line of credit	$ -	$ (1,000)
Payment on notes payable and		

capital lease obligations		-		(6,000)
Payment to extinguish debt		(165,000)		-
Net cash provided by (used in) financing activities		(165,000)		(7,000)
Net increase (decrease) in cash and cash equivalents		(11,361,000)		(825,000)
Cash and cash equivalents, beginning of period		16,187,000		1,575,000
Cash and cash equivalents, end of period	**$**	**4,826,000**	**$**	**750,000**
Supplemental disclosure of cash flow information				
Interest paid	**$**	**-**	**$**	**3,000**
Income taxes paid	**$**	**-**	**$**	**-**
Supplemental schedule of non- cash investing and financing activities				
Conversion of preferred stock to common stock	**$**	**-**	**$**	**14,000**

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

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ENOVA SYSTEMS, INC.

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 - Basis of Presentation

The accompanying unaudited financial statements have been prepared from the records of our company without audit and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not contain all the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position at March 31, 2006 and the interim results of operations for the three months ended March 31, 2006 and cash flows for the three months ended March 31, 2006 have been included. The balance sheet at December 31, 2005, presented herein, has been prepared from the audited financial statements of our company for the year then ended.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions affecting the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. The March 31, 2006 and December 31, 2005 inventories are reported at the lower of cost or market value. Inventories have been valued on the basis that they would be used, converted and sold in the normal course of business. The amounts estimated for the above, in addition to other estimates not specifically addressed, could differ from actual results; and the difference could have a significant impact on the financial statements.

Accounting policies followed by us are described in Note 1 to the audited financial statements for the fiscal year ended December 31, 2005. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted for purposes of the interim financial statements. The financial statements should be read in conjunction with the audited financial statements, including the notes thereto, for the year ended December 31, 2005, which are included in our Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 as filed with the Securities and Exchange Commission.

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

The results of operations for the three months ended March 31, 2006 presented herein are not necessarily indicative of the results to be expected for the full year.

Stock Based Compensation

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

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

The Company uses the Black-Scholes option-pricing model for estimating the fair value of options granted. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. The Company uses projected volatility rates, which are based upon historical volatility rates, trended into future years. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company s options. For purposes of pro forma disclosures, the estimated fair values of the options are amortized over the options vesting periods.

Stock Option Program Description

As of March 31, 2006, the Company had one stock incentive plan: the 1996 Stock Incentive Plan (the 1996 Plan).

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

The maximum number of shares issuable over the term of the 1996 Plan is limited to 65 million shares. Options granted under the 1996 Plan typically have an exercise price of 100% of the fair market value of the underlying stock on the grant date and expire no later than ten years from the grant date.

Options issued to executives will vest based on the Company achieving certain revenue milestones for the years ended December 31, 2005 and 2006. If such milestones are not met, the options with respect to those milestones will terminate. Options issued to employees will vest in equal installments over 36 months. All of the granted options will remain in effect for a period of 10 years or until 90 days after the employment of the optionee terminates.

Diluted shares outstanding include the dilutive effect of in-the-money options. As of March 31, 2006, and on December 31, 2005, the Company did not have any in-the-money options, and therefore, there was no dilutive effect relating to stock options outstanding on the 1996 plan.

Current quarter ended March 31, 2006

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 $14,000 for the three months ended March 31, 2006, 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:

Income from continuing operations before income taxes	$14,000
Income from continuing operations after income taxes	$14,000
Cash flows from operations	$14,000
Cash flows from financing activities	$ -
Basic and Diluted EPS	$ -

During the quarter ended March 31, 2006, the Company granted options to two executives under its 1996 Plan to purchase a total of 46,000 shares of common stock at an exercise price of between $3.95 and $5.25 per share. These options will vest based on the Company achieving certain revenue milestones for the year ended December 31, 2006. If such milestones are not met, the options with respect to those milestones will terminate. All of the granted options will remain in effect for a period of 10 years or until 90 days after the employment of the optionee terminates. The Company has not recognized compensation expense related to the granting of performance based options to certain executives in 2006, as the measure for the vesting of these options has been deemed as unlikely by management.

As of March 31, 2006, the total compensation cost related to non-vested awards not yet recognized is $137,000. The weighted average period over which the future compensation cost is expected to be recognized is 30 months. The aggregate intrinsic value of total awards outstanding, is zero.

General Option Information

A summary of option activity follows:

	1996 Plan		
	Shares	Weighted Average Exercise Price	
Outstanding, December 31, 2004	164,000	$	5.40
Granted	310,000	$	4.35
Exercised	-		-

Forfeited	(38,000)	$	7.64
Outstanding December 31, 2005	436,000	$	4.46
Granted	46,000	$	4.6
Exercised	-		-
Forfeited	(148,000)	$	4.85
Outstanding March 31, 2006	334,000	$	4.31
Exercisable, March 31, 2006	166,000	$	5.00

The weighted-average remaining contractual life of the options outstanding at March 31 2006 was 6.7 years. The exercise prices of the options outstanding at March 31, 2006 ranged from $4.35 to $8.10. The weighted-average remaining contractual life of the options outstanding at December 31, 2005 was 7 years. The exercise prices of the options outstanding at December 31, 2005 also ranged from $4.35 to $8.10. Options exercisable were 166,000 and 255,000, at March 31, 2006 and December 31, 2005, respectively.

Valuation and Expense Information under SFAS 123(R)

There was no stock-based compensation expense recognized for the three months ended December 31, 2005. Had the Company recognized compensation expense under the provisions of SFAS 123(R) for the three months ended December 31, 2005, the Company would have recognized $222,000 in compensation expense. Of the total compensation expense related to the three months ended December 31, 2005, $208,000 would have been attributable to the vesting of performance based options granted to executives, and $14,000 would have been attributable to employee options.

Revenue Recognition

From time to time, the Company enters into arrangements with its customers where there are multiple deliverables. In accordance with Emerging Issues Task Force Issue No. 00-21 Revenue Arrangements with Multiple Deliverables , when a company enters into these types of arrangements, the contract is divided into separate units of accounting based on relative fair values, and revenue recognition criteria are assessed separately for each separate unit of accounting. These elements will include product sales, service elements, and fixed-price development elements.

Revenues from Component Sales

Revenues from sales of components are recognized when shipped and title passes to the customer.

Service Revenue

Services revenues are billed and recognized in the period the services are rendered and earned and the collection of the related receivable is probable.

Method of Accounting for Long-Term Contracts

In accordance with the American Institute of Certified Public Accountant s Statement of Position 81-1, Accounting for Performance of Certain Construction-Type and Certain Product Type Contracts, the Company records its revenues on long-term, fixed price contracts on the basis of the percentage-of-completion method applied to individual contracts, commencing when progress reaches a point where experience is sufficient to estimate final results with reasonable accuracy and collection of the related receivable is probable.

That portion of the total contract price is accrued which is allocable, on the basis of the Company s estimates of the percentage-of-completion, to contract expenditures and work performed. Operating expenses, including indirect costs and administrative expenses, are charged to income as incurred and are not allocated to contract costs.

As these long-term contracts are performed, revisions in cost and profit estimates during the course of the work are recognized in the accounting period in which the facts which require the revision become known.

At the time a loss on a contract becomes known, the entire amount of the estimated ultimate loss on both short- and long-term contracts is accrued.

Recently Issued Pronouncement

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155). This statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and resolves issues addressed in SFAS 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interest in Securitized Financial Assets. The Company is required to apply SFAS 155 to all financial instruments acquired, issued or subject to a re-measurement event beginning January 1, 2007, although early adoption is permitted as of the beginning of an entity s fiscal year. The provisions of SFAS 155 are not expected to have an impact on the financial statements at adoption.

On March 17, 2006, the FASB issued Statement No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140"("SFA