ENOVA SYSTEMS INC
Form 10-Q
August 14, 2009

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

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

For the quarterly period ending June 30, 2009

or

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

For the transition period from __________ to __________

Commission file no. 1-33001

ENOVA SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

1560 West 190th Street, Torrance, California 90501

(Address of principal executive offices, including zip code)

(310) 527-2800

(Registrant s telephone number, including area code)

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

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

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

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

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

As of July 31, 2009, there were 20,960,908 shares of common stock outstanding.

ENOVA SYSTEMS, INC.
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ENOVA SYSTEMS, INC.
BALANCE SHEETS

	June 30, 2009 (unaudited)	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,443,000	$ 5,324,000
Short term investments	200,000	2,000,000
Accounts receivable, net	418,000	808,000
Inventories and supplies, net	8,015,000	7,649,000
Prepaid expenses and other current assets	343,000	215,000
Total current assets	14,419,000	15,996,000
Property and equipment, net	1,647,000	1,829,000
Investment in non-consolidated joint venture		1,352,000
Intangible assets, net	63,000	65,000
Total assets	$ 16,129,000	$ 19,242,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 849,000	$ 592,000
Deferred revenues	670,000	
Accrued payroll and related expenses	226,000	295,000
Other accrued liabilities	1,089,000	1,859,000
Current portion of notes payable	81,000	98,000
Total current liabilities	2,915,000	2,844,000
Accrued interest payable	1,033,000	992,000
Notes payable, net of current portion	1,284,000	1,263,000
Total liabilities	5,232,000	5,099,000
Stockholders equity:		
Series A convertible preferred stock no par value, 30,000,000 shares authorized; 2,652,000 issued and outstanding; liquidating preference at $0.60 per share as of June 30, 2009 and December 31, 2008	530,000	530,000
Series B convertible preferred stock no par value, 5,000,000 shares authorized; 546,000 shares issued and outstanding; liquidating preference at $2 per share as of June 30, 2009 and December 31, 2008	1,094,000	1,094,000
Common Stock no par value, 750,000,000 shares authorized; 20,961,000 and 20,817,000 shares issued and outstanding as of June 30, 2009 and December 31, 2008, respectively	134,447,000	134,233,000
Additional paid-in capital	8,179,000	7,949,000
Accumulated deficit	(133,353,000)	(129,663,000)

Total stockholders equity		10,897,000		14,143,000
Total liabilities and stockholders equity	$	16,129,000	$	19,242,000

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

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ENOVA SYSTEMS, INC.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Revenues	$ 576,000	$ 3,370,000	$ 1,264,000	$ 5,648,000
Cost of revenues	613,000	3,736,000	1,192,000	6,178,000
Gross profit (loss)	(37,000)	(366,000)	72,000	(530,000)
Operating expenses				
Research and development	335,000	712,000	589,000	1,340,000
Selling, general & administrative	1,570,000	1,935,000	3,065,000	3,849,000
Total operating expenses	1,905,000	2,647,000	3,654,000	5,189,000
Gross operating loss	(1,942,000)	(3,013,000)	(3,582,000)	(5,719,000)
Other income and (expense)				
Interest and other income (expense)	(98,000)	69,000	(104,000)	154,000
Gain (loss) from non-consolidated joint venture	6,000	(6,000)	(4,000)	(58,000)
Total other income (expense)	(92,000)	63,000	(108,000)	96,000
Net loss	$ (2,034,000)	$ (2,950,000)	$ (3,690,000)	$ (5,623,000)
Basic and diluted loss per share	$ (0.10)	$ (0.15)	$ (0.18)	$ (0.30)
Weighted average number of shares outstanding	20,896,000	20,054,000	20,871,000	18,623,000

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

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

	For the Six Months Ended June 30,	
	2009	**2008**
Cash flows from operating activities:		
Net loss	$ (3,690,000)	$ (5,623,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Reserve for doubtful accounts		70,000
Inventory reserve	240,000	
Depreciation and amortization	318,000	261,000
Loss (gain) on asset disposal	3,000	(6,000)
Equity in losses of non-consolidated joint venture	10,000	58,000
Gain from dissolution of non-consolidated joint venture	(6,000)	
Issuance of common stock for director services	90,000	84,000
Issuance of common stock for employee services	124,000	21,000
Stock option expense	230,000	273,000
(Increase) decrease in:		
Accounts receivable	380,000	98,000
Inventory and supplies	469,000	(3,190,000)
Prepaid expenses and other current assets	(24,000)	156,000
Increase (decrease) in:		
Accounts payable	334,000	(228,000)
Deferred revenues	670,000	(67,000)
Accrued payroll and related expense	(69,000)	(364,000)
Accrued liabilities	(805,000)	290,000
Accrued interest payable	41,000	59,000
Net cash used in operating activities	(1,685,000)	(8,108,000)
Cash flows from investing activities:		
Purchases of short-term investments	(200,000)	(2,000,000)
Maturities of short-term investments	2,000,000	
Proceeds from dissolution of non-consolidated joint venture	137,000	
Purchases of property and equipment	(100,000)	(1,411,000)
Net cash provided by (used in) investing activities	1,837,000	(3,411,000)
Cash flows from financing activities:		
Payments on notes payable	(33,000)	(27,000)
Net cash proceeds from the sale of common stock		12,024,000
Net cash provided by (used in) financing activities	(33,000)	11,997,000
Net increase (decrease) in cash and cash equivalents	119,000	478,000
Cash and cash equivalents, beginning of period	5,324,000	10,485,000

Cash and cash equivalents, end of period	$ 5,443,000	$ 10,963,000
Supplemental disclosure of cash flow information:		
Interest paid	$ 4,000	$ 5,000
Assets acquired through financing arrangements	$ 38,000	$
Net assets acquired in exchange for Enova s interest in joint venture:		
Inventory	$ 1,075,000	$
Prepaid expenses and other current assets	$ 104,000	$
Reduction of related party payable, net of receivable	$ 32,000	$

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

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ENOVA SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
(Unaudited)
Three and Six months ended June 30, 2009 and 2008

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

Basis of Presentation Interim Financial Statements

The financial information as of and for the six months ended June 30, 2009 and 2008 is unaudited but includes all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair statement of its financial position at such dates and the operating results and cash flows for those periods. The year-end balance sheet data was derived from audited financial statements, and certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to SEC rules or regulations; however, the Company believes the disclosures made are adequate to make the information presented not misleading.

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

The results of operations for the interim periods presented are not necessarily indicative of the results of operations to be expected for the fiscal year. These condensed interim financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2008, which are included in the Company s Annual Report on Form 10-K for the year then ended.

Certain reclassifications have been made to the prior years financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or stockholders equity.

Fair Value of Financial Instruments

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

Revenue Recognition

The Company manufactures proprietary products and other products based on design specifications provided by its customers. The Company recognizes revenue only when all of the following criteria have been met:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services have been rendered;

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The fee for the arrangement is fixed or determinable; and

Collectibility is reasonably assured.

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

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

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

Collectibility is Reasonably Assured The Company determines that collectibility is reasonably assured prior to recognizing revenue. Collectibility is assessed on a customer-by-customer basis based on criteria outlined by management. New customers are subject to a credit review process which evaluates the customer s financial position and ultimately its ability to pay. The Company does not enter into arrangements unless collectibility is reasonably assured at the outset. Existing customers are subject to ongoing credit evaluations based on payment history and other factors. If it is determined during the arrangement that collectibility is not reasonably assured, revenue is recognized on a cash basis. 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.

Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board Issue 00-21 addresses 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

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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.

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. 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).

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

3. Inventory

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

	June 30, 2009	**December 31, 2008**
Raw Materials	$ 7,716,000	$ 7,114,000
Work In Progress	320,000	391,000
Finished Goods	747,000	1,047,000
Reserve for Obsolescence	(768,000)	(903,000)
Total	$ 8,015,000	$ 7,649,000

4. Property and Equipment

Property and equipment consisted of the following at:

	June 30, 2009	**December 31, 2008**
Computers and software	$ 550,000	$ 598,000
Machinery and equipment	959,000	1,470,000
Furniture and office equipment	98,000	107,000
Demonstration vehicles and buses	485,000	346,000
Leasehold improvements	1,348,000	1,348,000
	3,440,000	3,869,000
Less accumulated depreciation	(1,793,000)	(2,040,000)
Total	$ 1,647,000	$ 1,829,000

Depreciation expense was $316,000 and $259,000 for the six months ended June 30, 2009 and 2008, respectively.

During the first half of this year, the Company made an evaluation of fixed asset records that resulted in the disposal of obsolete production equipment, computers and furniture totaling approximately $566,000 with accumulated depreciation of approximately $563,000 that were no longer being utilized in our operations.

5. Other Accrued Liabilities

Other accrued liabilities consisted of the following at:

	June 30,	**December 31,**

	2009	2008
Accrued Inventory Received	$ 389,000	$ 743,000
Accrued Professional Services	170,000	571,000
Accrued Warranty	530,000	545,000
Total	$ 1,089,000	$ 1,859,000

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

Notes payable consisted of the following at:

	June 30, 2009	December 31, 2008
Secured note payable to Credit Managers Association of California, bearing interest at prime plus 3% (6.25% as of June 30, 2009), and is adjusted annually in April through maturity. Principal and unpaid interest due in April 2016. A sinking fund escrow may be funded with 10% of future equity financing, as defined in the Agreement	$ 1,238,000	$ 1,238,000
Secured note payable to a financial institution in the original amount of $95,000, bearing interest at 6.21%, payable in 36 equal monthly installments of principal and interest through October 1, 2009	10,000	27,000
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	7,000	14,000
Secured note payable to a financial institution in the original amount of $23,000, bearing interest at 11.70%, payable in 36 equal monthly installments of principal and interest through October 1, 2010	12,000	15,000
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	23,000	27,000
Secured note payable to a financial institution in the original amount of $38,000, bearing interest at 8.25% per annum, payable in 60 equal monthly installments of principal and interest through February 19, 2014	35,000	
	1,365,000	1,361,000
Less current portion	(81,000)	(98,000)
Long-term portion	$ 1,284,000	$ 1,263,000

As of June 30, 2009 and December 31, 2008, the balance of long term interest payable with respect to the Credit Managers Association of California note amounted to $1,015,000 and $976,000, respectively.

7. 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, which was secured by a $2,000,000 certificate of deposit. The facility expired on June 30, 2009.

In June 2009, the Company renewed the Credit Agreement at a reduced principal amount of $200,000 for a one-year term maturing on June 30, 2010. The agreement is secured by a $200,000 certificate of deposit. The interest rate on a drawdown from the facility is the certificate of deposit rate plus 1.25% with interest payable monthly and the principal due at maturity. The financial institution also renewed the $200,000 irrevocable letter of credit for the full amount of the credit facility in favor of Sunshine Distribution LP (Landlord), with respect to the lease of the Company s corporate headquarters at 1560 West 190th Street, Torrance, California.

8. Shareholders Equity

Changes in shareholders equity were as follows for the six months ended June 30, 2009 and 2008:

	2009	2008
Beginning balance	$ 14,143,000	$ 14,177,000
Increase in additional paid-in-capital for stock-based compensation	230,000	273,000
Increase in common stock for issuances of common shares to directors	90,000	84,000
Increase in common stock for issuances of common shares to employees	124,000	21,000
Net proceeds from the sale of common stock		12,024,000
Net loss	(3,690,000)	(5,623,000)
End balance	$ 10,897,000	$ 20,956,000

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9. Related Party Transactions

During the six months ended June 30, 2009 and June 30, 2008, the Company purchased $1,075,000 and $1,063,000, respectively, in components materials or services from Hyundai Heavy Industries (HHI), a related party. As of June 30, 2009, the Company has a remaining outstanding deposit balance with HHI of approximately $104,000 from the ITC joint venture dissolution for which inventory is expected be delivered in the third quarter. The Company had a payables balance to HHI of approximately zero and $467,000 as of June 30, 2009 and 2008, respectively.

10. Subsequent Events

None.

11. Stock Options

Stock Option Program Description

As of June 30, 2009, the Company had one equity compensation plan, the 2006 Equity Compensation Plan (the 2006 Plan). The 1996 Stock Option Plan (the 1996 Plan) has expired for the purposes of issuing new grants. However, the 1996 Plan will continue to govern awards previously granted under that plan. The 2006 Plan has been approved by the Company s Shareholders. Equity compensation grants are designed to reward employees and executives for their long term contributions to the Company and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants are based on competitive practices, operating results of the company, and government regulations.

The 2006 Plan has a total of 3,000,000 shares reserved for issuance, of which 2,040,000 shares were available for grant as of June 30, 2009. All stock options have terms of between five and ten years and generally vest and become fully exercisable from two to three years from the date of grant. As of June 30, 2009, the Company had 1,056,000 options outstanding which were comprised of issuances under the 1996 Plan and the 2006 Plan of 97,000 and 959,000, respectively.

In conjunction with the adoption of SFAS 123(R), the Company attributed the value of share-based compensation to expense using the straight-line method. Share-based compensation expense related to stock options was $126,000 for the three months ended June 30, 2009.

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

	For the three months ended		For the six months ended	
	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
Income from continuing operations before income taxes	$126,000	$184,000	$230,000	$273,000
Income from continuing operations after income taxes	$126,000	$184,000	$230,000	$273,000
Cash flows from operations	$126,000	$184,000	$230,000	$273,000
Cash flows from financing activities	$	$	$	$
Basic and Diluted EPS	$ 0.01	$ 0.01	$ 0.01	$ 0.01

As of June 30, 2009, the total compensation cost related to non-vested awards not yet recognized is $972,000. The weighted average period over which the future compensation cost is expected to be recognized is 24 months. The aggregate intrinsic value represents the total pretax intrinsic value, which is the difference between the Company s closing stock price on the last trading day of the second quarter of fiscal 2009 of $0.70 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, 2009. This amount will change based on the fair market value of the Company s stock.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2009:

	Number of Share Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years		Aggregate Intrinsic Value
Outstanding at December 31, 2008	623,000	$	4.02	7.09	$	
Granted	515,000	$	0.63	8.10	$	74,000
Exercised		$			$	
Forfeited	(82,000)	$	3.82		$	
Outstanding at June 30, 2009	1,056,000	$	2.38	7.33	$	74,000
Exercisable at June 30, 2009	409,000	$	3.64	6.02	$	18,000

The weighted-average remaining contractual life of the options outstanding at June 30, 2009 was 7.33 years. The exercise prices of the options outstanding at June 30, 2009 ranged from $0.21 to $4.95. Options exercisable were 409,000 and 387,000 at June 30, 2009 and December 31, 2008, respectively. The weighted average grant-date fair value of options granted during the three and six months ended June 30, 2009 was $0.76 and $0.59, respectively, and was $3.21 and $2.87 for options granted during the three and six months ended June 30, 2008, respectively. The Company s policy is to issue shares from its authorized shares upon the exercise of stock options.

The fair values of all stock options granted during the three and six months ended June 30, 2009 and 2008 were estimated on the date of grant using the Black-Scholes option-pricing model with the following range of assumptions:

	For the three months ended June 30,		For the six months ended June 30,	
	2009	2008	2009	2008
Expected life (in years)	4	4	4	4
Average risk-free interest rate	2%	3%	2%	3%
Expected volatility	194%	113%	194%	111% to 113%
Expected dividend yield	0%	0%	0%	0%
Forfeiture rate	3%	3%	3%	3%

The estimated fair value of grants of stock options and warrants to nonemployees of the Company is charged to expense, if applicable, in the financial statements. These options vest in the same manner as the employee options granted under each of the option plans as described above.

12. Recent Accounting Pronouncements

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP 157-4), and FSP FASB 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP 107-1), which amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about the fair value of financial instruments that are not currently reflected on a company s balance sheet for interim reporting periods as well as annual reporting periods. These two staff positions relate to fair value measurements and related disclosures. The FASB also issued a third FSP relating to the accounting for impaired debt securities titled FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of*

Other-Than-Temporary Impairments (FSP 115-2). These standards are effective for interim and annual periods ending after June 15, 2009. The Company has determined that FSP 157-4 and FSP 115-2 do not currently apply to its activities and has adopted the disclosure requirements of FSP 107-1.

In May 2009, the FASB issued Statement No. 165, Subsequent Events (SFAS 165), which establishes general standards of accounting for, and requires disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company adopted the provisions of SFAS 165 for the quarter ended June 30, 2009. The adoption of this provision did not have a material effect on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets*, *an amendment to SFAS No. 140* (SFAS 166). SFAS 166 eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets, including securitization transactions, and an entity s continuing involvement in and exposure to the risks related to transferred financial assets. SFAS 166 is effective for fiscal years beginning after November 15, 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. The Company will adopt SFAS 166 in fiscal 2010.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167). The amendments include: (1) the elimination of the exemption for qualifying special purpose entities, (2) a new approach for determining who should consolidate a variable-interest entity, and (3) changes to when it is necessary to reassess who should consolidate a variable-interest entity. SFAS 167 is effective for the first annual reporting period beginning after November 15, 2009 and for interim periods within that first annual reporting period. 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. The Company will adopt SFAS 166 in fiscal 2010.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (SFAS 168). SFAS 168 replaces FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, and establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). SFAS 168 is effective for interim and annual periods ending after September 15, 2009. The Company will begin to use the new Codification when referring to GAAP in its quarterly report on Form 10-Q for the quarter ending September 30, 2009. The implementation of this standard will not have an impact on the consolidated results of the Company.

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 ne 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, 2008.

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, 2008.

Overview

Enova believes it is a leader in the development and production of proprietary, commercial digital power management systems for transportation vehicles and stationary power generation systems. Power management systems control and monitor electric power in an automotive or commercial application such as an automobile or a stand-alone power generator. Electric drive systems are comprised of an electric motor, an electronics control unit, a gear unit and batteries 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. Our hybrid systems can alternatively utilize a hydrogen fuel cell or a microturbine as a power source to recharge the battery system. Stationary power systems utilize similar components to those which are in a mobile drive system in addition to other elements.

A fundamental element of Enova s strategy is to develop and produce advanced proprietary software, firmware and hardware for applications in these alternative power markets. Our focus is digital power conversion, power management, and system integration, focusing chiefly on vehicle 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. Additionally, we perform research and development (R&D) to augment and support others and our own related product development efforts.

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

Enova s primary market focus centers on both electric series and parallel hybrid medium and 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. By aligning ourselves with key customers in our target markets, we believe that alliances will result in the latest technology being implemented and customer requirements being met, with an optimized level of additional time or expense. As we penetrate more market areas, we are continually refining both our market strategy and our product line to maintain our leading edge in power management and conversion systems for mobile applications.

Our website, www.enovasystems.com, contains up-to-date information on our company, our products, programs and current events. Our website is a prime focal point for current and prospective customers, investors and other affiliated parties seeking data on our business.

Recent Developments

In April 2009, our customer Navistar (International Truck and Engine, IC Corporation) was selected to receive a cost-shared award of up to $10 million under the Department of Energy Plug-in Hybrid Electric Vehicle (PHEV) Technology Acceleration and Deployment Activity program to develop and deploy 60 plug-in electric hybrid school buses, including engine-off all-electric drive capability. We believe that these awards will result in a greatly improved value proposition for customers. Navistar has also finalized several sales incentive programs, including a universal extended warranty of up to 12 years in certain targeted markets and dedicated funding specialists to pursue product funding and tax incentives for dealers and customers. Enova is working closely with Navistar in support of these initiatives.

After successfully implementing twenty of our pre-transmission parallel hybrid systems at last year s Beijing Olympics, First Auto Works (FAW) of China has placed orders for 220 units of our hybrid systems for deliveries concentrated in the second half of the year, which represents the start of sustained volume production for this OEM. Furthermore, we have executed a supply agreement with FAW to supply an additional 800 units in 2010. In addition, the government of China issued a three-year development plan in February of this year to produce 500,000 electric and hybrid vehicles per year, or 5% of the Chinese vehicle market. As part of this initiative, the government is offering subsidies of up to 600,000 yuan that will cover about half of the cost of each bus in thirteen trial cities, including Beijing, Shanghai, Changchun, Dalian and Shenzhen. The municipal government of Dalian has confirmed that at least fifty hybrid buses will be running in the city of Changchun during the World Economic Forum s Summer event to be held in September 2009, all of which will feature Enova s drive systems.

In the second quarter of 2009, we completed the commercialization of our all electric zero emission (Ze) drive train. The Enova Ze step van further demonstrates our advanced drive systems capabilities and allows both vehicle original equipment manufacturers (OEMs) and operators the opportunity to evaluate our capabilities firsthand. In the second quarter of 2009, Enova completed a Department of Energy Electrification grant application for Enova to convert and place Ze step vans to further enable the market acceptance of this technology. Additionally, in the second quarter of 2009, the Enova Ze drive train was demonstrated to several world leading early adopter OEMs. Additional OEM and fleet visits are scheduled. In the third and fourth quarter of 2009, Enova will engage in a sustained visibility campaign with the objective of bringing the Enova Ze drive train into production.

Throughout the second quarter of 2009, we continued to host and visit potential as well as existing customers from the Pick Up and Delivery, Medium Duty and Heavy Duty markets. We continue to mature these relationships, as we believe they will eventually

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lead to viable business relationships. Additionally, Enova has explored several retrofit strategies and consulted with our fleet partners to place evaluation vehicles in the field. We believe that the non-invasive and versatile nature of Enova s post transmission hybrid designs position our company as a highly viable production alternative in the market today. Economic factors, including lengthened vehicle service lives, government funding opportunities, and more affordable energy storage, indicate that a positive vehicle payback point is achievable in a retrofit application.

In April 2009, Enova submitted a loan and grant application to the U.S. Department of Energy Advanced Technology Vehicles Manufacturing (ATVM) Loan Program under Section 136 of the Energy Independence and Security Act of 2007. Enova applied for the funding of $13.6 million for a light duty drive system with the goal of commercialization of the associated components. In July 2009, we received notice from the DOE that our loan application was substantially complete. The ATVM Loan Program provides loans to automobile and automobile part manufacturers for the cost of equipping, expanding, or establishing manufacturing facilities in the United States to produce light-duty vehicles and components for such vehicles which provide targeted improvements in fuel economy performance beyond certain specified levels. Section 136 also provides that grants and loans may cover engineering integration costs associated with such projects.

As part of the American Recovery and Reinvestment Act of 2009, the U.S. Department of Energy also announced funding opportunities in the form of cost-share grants for supporting the construction of U.S. based manufacturing plants to produce batteries, electric drive components, and to establish development, demonstration, evaluation, and education projects to accelerate the market introduction and penetration of advanced electric drive vehicles. In August 2009, we received notice from the Department of Energy that grant money is not available for Enova at this time. However, Smith Electric Vehicles U.S. subsidiary received a grant of $10 million under this program to accelerate the production plans at their new U.S. manufacturing facility. As production is ramped up, we anticipate the opportunity to continue supply of our all-electric vehicle drive systems that are used to power Smith s Newton trucks. Additionally, Navistar Truck also received a grant of $39M to build an electric truck manufacturing facility and develop associated technologies. Enova will attempt to supply Navistar Truck with EV drive systems to support this manufacturing line.

The California Air Resources Board (CARB) through AB 118, highlighted in a meeting notice that a $25 million voucher incentive program would be implemented to accelerate the deployment of about 1,000 hybrid trucks and buses in California. CARB also announced an advanced technology demonstration project of $3 million for transit and school buses. Enova believes these programs will lower the acquisition cost of a hybrid school bus for our California customers and create another funding opportunity for our current initiatives in the hybrid school bus market.

Enova has incurred significant operating losses in the past. As of June 30, 2009, we had an accumulated deficit of approximately $133.4 million. We expect to incur additional operating losses until we achieve a level of product sales sufficient to cover our operating and other expenses. However, the Company believes that its business outlook will improve, especially in light of government policies being implemented in the United States, China and the United Kingdom regarding the curbing of green house gas emissions in the future as well as intentions to provide government incentives that may induce consumption of our products and services.

We continue to receive greater recognition from both governmental and private industry with regards to both commercial and military application of our hybrid drive systems and fuel cell power management technologies. Although we believe that current negotiations with various parties may result in production contracts during 2009 and beyond, there are no assurances that such additional agreements will be realized.

During the second quarter of 2009, we also continued to develop and produce electric and hybrid electric drive systems and components for other major customers as well, including HCATT and United Kingdom bus manufacturers including Tanfield Engineering Systems and Optare UK Limited, as well as several other domestic and international vehicle and bus manufacturers. 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.

Dissolution of Joint Venture Hyundai-Enova Innovative Technology Center

On April 6, 2009, Enova Systems Inc. and Hyundai Heavy Industries of Korea (HHI) agreed to dissolve their 60/40 joint venture, Hyundai-Enova Innovative Technology Center, Inc. (ITC), by mutual agreement based on their evaluation of the joint venture and its business relationship to each of Enova and HHI. ITC was originally established in 2003 as a technical center for specified products with Enova as the commercial manager, ITC as the engineering and development venture and HHI as the primary components supplier.

In connection with the dissolution of ITC, Enova, HHI and ITC entered into a Joint Venture Dissolution and Termination Agreement, effective as of April 6, 2009 (the Dissolution Agreement), pursuant to which, among other things, the parties terminated each of: (a) the Joint Venture Agreement between Enova and HHI, (b) the License and Technology Transfer Agreement between HHI and ITC (and all amendments and modifications thereto), (c) the License Transfer Agreement between Enova and ITC (and all amendments and modifications thereto), (d) the Manufacturing and Sales Agreement between Enova, HHI and ITC (and all amendments and modifications thereto), (e) the Manufacturing and Sales Agreement between HHI and ITC (and all amendments and modifications thereto) and (f) the License Agreement among U.S. Electricar, Inc., Hyundai Motor Company, and Hyundai Electronics Co., Ltd. (and all amendments and modifications thereto).

The Dissolution Agreement required Enova and ITC to enter into a Stock Purchase Agreement, dated as of April 6, 2009. Pursuant to the Stock Purchase Agreement, ITC re-purchased the 2,000,000 shares of common stock of ITC owned by Enova, which represented 40% of the issued shares of ITC, for a purchase price of $1,334,097 with HHI becoming the sole shareholder of ITC immediately subsequent to this transaction. Enova received from ITC a cash payment of $137,218 and, as was agreed under the Dissolution Agreement, the amount of $1,196,879 was paid to HHI to settle open purchase orders that Enova had placed with HHI for electrical component inventory which are expected to become part of salable systems; and settled other payables and receivables between Enova and HHI and ITC. As of June 30, 2009, Enova received approximately $1,075,000 in inventory from HHI as part of the ITC settlement and had unfulfilled open purchase orders with HHI in the amount of approximately $104,000.

The summary of the ITC dissolution is as follows:

	Amount
Cash received at settlement	$ 137,000
Inventory received during the second quarter in settlement of purchase orders with HHI for Enova s share in joint venture	1,075,000
Open purchase orders with HHI to be received in the third quarter	104,000
Related party receivables and payables settled for Enova s share in joint venture	32,000
Settlement amount	1,348,000
Less: Joint venture investment balance as of April 6, 2009	(1,342,000)
Net gain resulting from dissolution of the joint venture	$ 6,000

HHI continues to be a key strategic supplier of components for Enova, including electric drive motors and control electronic units that are manufactured using Enova specifications.

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, 2008.

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 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.

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RESULTS OF OPERATIONS

Three and Six Months Ended June 30, 2009 compared to Three and Six Months Ended June 30, 2008

Second Quarter of Fiscal 2009 vs. Second Quarter of Fiscal 2008

	Three Months Ended June 30,			As a % of Revenues June 30,	
	2009	**2008**	**% Change**	**2009**	**2008**
Revenues	$ 576,000	$ 3,370,000	-83%	100%	100%
Cost of revenues	613,000	3,736,000	-84%	106%	111%
Gross profit (loss)	(37,000)	(366,000)	90%	-6%	-11%
Operating expenses					
Research and development	335,000	712,000	-53%	58%	21%
Selling, general & administrative	1,570,000	1,935,000	-19%	273%	57%
Total operating expenses	1,905,000	2,647,000	-28%	331%	79%
Gross operating loss	(1,942,000)	(3,013,000)	36%	-337%	-89%
Other income and (expense)					
Interest and other income (expense)	(98,000)	69,000	-242%	-17%	2%
Gain (loss) from non-consolidated joint venture	6,000	(6,000)	-200%	1%	0%
Total other income (expense)	(92,000)	63,000	-246%	-16%	2%
Net loss	$ (2,034,000)	$ (2,950,000)	31%	-353%	-88%

First Six Months of Fiscal 2009 vs. First Six Months of Fiscal 2008

	Six Months Ended June 30,			As a % of Revenues June 30,	
	2009	**2008**	**% Change**	**2009**	**2008**
Revenues	$ 1,264,000	$ 5,648,000	-78%	100%	100%
Cost of revenues	1,192,000	6,178,000	-81%	94%	109%
Gross profit (loss)	72,000	(530,000)	114%	6%	-9%
Operating expenses					
Research and development	589,000	1,340,000	-56%	47%	24%
Selling, general & administrative	3,065,000	3,849,000	-20%	242%	68%
Total operating expenses	3,654,000	5,189,000	-30%	289%	92%
Gross operating loss	(3,582,000)	(5,719,000)	37%	-283%	-101%

Other income and (expense)					
Interest and other income (expense)	(104,000)	154,000	-168%	-8%	3%
Gain (loss) from non-consolidated joint venture	(4,000)	(58,000)	-93%	0%	-1%
Total other income (expense)	(108,000)	96,000	-213%	-9%	2%
Net loss	$ (3,690,000)	$ (5,623,000)	34%	-292%	-100%

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. Net revenues decreased by $4,384,000 or 78% for the six months ended June 30, 2009 to $1,264,000 as compared to $5,648,000 for the corresponding period in 2008. Revenues for the three months ended June 30, 2009 decreased by 83% to $576,000 from $3,370,000 in the corresponding period in 2008. Revenues in the current year were derived primarily from fulfillment of orders from First Auto Works of China (FAW), Navistar Corporation, the Hawaii Center for Advanced Transportation Technologies (HCATT) and the Tanfield Group Plc (Tanfield). The decline in revenue in the first half of 2009 compared to the prior year is due to the fulfillment of large volume sales of our hybrid systems to Tanfield, which accounted for nearly 40% of sales, as well as the completion of several small low volume contracts for other customers. In addition, domestic revenues in the current year were impacted by the effect of the economic slowdown on capital expenditures. We continue to improve the awareness of our product and service offerings with customers based on our robust research and product development initiatives as well as our production capacity. Although we have seen indications for future production growth, as discussed in the Overview above, there can be no assurance there will be continuing demand for our products and services.

Cost of Revenues. Cost of revenues consists of component and material costs, direct labor costs, integration costs and overhead related to manufacturing our products as well as inventory valuation reserve amounts. Cost of revenues for the six and three months ended June 30, 2009 decreased to $1,192,000, or -81%, and $613,000, or -84%, respectively from $6,178,000 and $3,736,000, respectively for the same periods in 2008 primarily due to the decrease in revenue. Excluding net inventory reserve adjustments, the cost of revenues would have been 84% of revenues in the first half of 2009 and would have been 105% of revenue in the same period of the prior year. The improvement in the cost of revenue percentage is primarily attributable to our continuing focus on manufacturing and inventory processes that resulted in tighter control over production costs.

Gross Margin. Gross margin improved for the six months ended June 30, 2009 to a profit of $72,000 (6% of revenue) from a loss of $530,000 (-9% of revenue) in the same period in 2008. Gross margin also improved for the three months ended June 30, 2009 to a negative 6% from a negative 11% in the same period in 2008. Excluding the effect of inventory adjustments, as discussed above, gross margin for the six months ended June 30, 2009 would have been 16% and would have been, negative 5% in the corresponding period in 2008. The improvement in gross margin is primarily attributable to our focus on key customer production contracts, maturity of our supply chain, and efficiencies gained through focus on manufacturing and inventory processes that resulted in tighter controls over production costs. As we complete delivery of major production contracts in the second half of this year, we expect to achieve continued benefit from these initiatives, although we may continue to experience variability in our gross margin.

Research and Development (R&D). Internal research, development and engineering expenses decreased $751,000 or 56% in the six months ended June 30, 2009 to $589,000 from $1,340,000 for the same period in 2008. In the three months ended June 30, 2009, R&D costs decreased $377,000, or 53%, to $335,000 from $712,000 in the prior year period. R&D costs were higher in the first six months of 2008 due to expenditures to complete the development of our wireless tracking module, a one-time cost incurred for a dynamometer testing of our hybrid system and a higher level of resources expended for development projects. In the first six months of 2009, R&D efforts were focused on development of our new Ze all electric vehicle, an upgraded motor control unit, engine off capability for our post transmission parallel hybrid drive system as well as testing of new battery technologies, and development resources utilized in support of non core development projects were reduced due to the current operating environment. We also continued to allocate necessary resources to the development of upgraded proprietary control software, enhanced DC-DC converters and digital inverters as well as other power management firmware.

Selling, General, and Administrative Expenses (S, G & A). Selling, general and administrative expenses decreased $784,000 or 20% for the six months ended June 30, 2009 to $3,065,000 from $3,849,000 for the same period in 2008. These expenses also decreased $365,000, or 19%, to $1,570,000 for the three months ended June 30, 2009 from $1,935,000 for the same period in 2008. The Company implemented a series of cost savings measures in response to the severe sales environment, including reducing employee headcount by over 50% from the 2008 peak, eliminating outside IT and marketing consultants and placing restrictions on travel and purchasing. In addition, the Company incurred approximately $300,000 of expenses for internal labor and other costs in the first three months of 2008 due to the move to our new manufacturing facility.

Interest and Other Income (Expense). Interest and Other Income (Expense) decreased by $167,000 and $258,000 to a net expense of $98,000 and $104,000 in the three and six months ended June 30, 2009, respectively, from a net income of $69,000 and $154,000 for the same periods in 2008. A loss of $88,000 was recorded in settlement of a vendor dispute in the second quarter of 2009. In addition, interest income decreased as a result of the Company having a smaller average cash balance and lower interest rates on cash balances between the respective periods in 2009 and 2008.

Net Loss. Net loss decreased by $1,933,000 or 34% for the six months ended June 30, 2009 to $3,690,000 from $5,623,000 for the same period in 2008. Net loss for the three months ended June 30, 2009 was $2,034,000, a decrease of $916,000 or 31% from $2,950,000 for the same period in 2008. The decrease in the net loss was due to improved profitability on sales and reduction in both S, G & A and internal research and development expenses in response to the current severe operating environment.

Comparability of Quarterly Results. Our quarterly results have fluctuated in the past and we believe they will continue to do so in the future. Certain factors that could affect our quarterly operating results are described in Part I, Item 1A-Risk Factors contained in our Form 10K for 2008. Due to these and other factors, we believe that quarter-to-quarter comparisons of our results of operations are not meaningful indicators of future performance.

LIQUIDITY AND CAPITAL RESOURCES

We have experienced cash flow shortages due to operating losses primarily attributable to research and development, marketing and other general and administrative 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 develop and/or acquire the capability to manufacture and sell our products profitably. Our operations during the year ended December 31, 2008 and six months ended June 30, 2009 were financed by product sales and equity issuances as well as from working capital reserves.

The Company has a secured revolving credit facility with a financial institution (the Credit Agreement) for $2,000,000 which expired on June 30, 2009. The Credit Agreement is secured by a $2,000,000 certificate of deposit (CD). In June 2009, the Company renewed the Credit Agreement at a reduced principal amount of $200,000, secured by a CD in the same amount, for a period of one year expiring on June 30, 2010. As a result, the amount of $1,800,000 in the CD was rolled over at maturity into cash. The interest rate is the certificate of deposit rate plus 1.25% with interest payable monthly and the principal due at maturity. As of June 30, 2009, the renewed Credit Agreement was fully drawn 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. We anticipate that the credit facility will be renewed with similar terms as the existing facility.

Net cash used in operating activities was $1,685,000 for the six months ended June 30, 2009 compared to $8,108,000 for the six months ended June 30, 2008. Cash used in operations for the first six months of 2009 decreased compared to 2008 due to lower purchases of inventory in line with current operational activity and lower personnel, operations and administrative expenditures. Cash used in operations in the first six months of 2008 was affected by the operating loss of $5,623,000 and purchases of inventory of $3,190,000 for anticipated sales to Tanfield. Non-cash items include expense for stock-based compensation, depreciation and amortization, and issuance of common stock for director and employee services. We continued to conserve cash resources through reductions in employee headcount and restrictions on administration and operating expenditures. As of June 30, 2009, the Company had $5,443,000 of cash and cash equivalents.

Net cash provided by investing activities was $1,837,000 for the first six months of 2009 compared to net cash used of $3,411,000 in the first six months of 2008. In 2009, in conjunction with the reduction of our credit facility, as explained above, we redeemed the certificate of deposit for $1,800,000 for use in operating activities. 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 $2 million CD for the credit facility.

Net cash used in financing activities totaled $33,000 for the first six months of 2009, compared to net cash provided by financing activities of $11,997,000 for the first six months of 2008. In the first six months of 2008, we completed two equity issuances raising approximately $12 million in net proceeds.

As of June 30, 2009, accounts receivable was $418,000, a 48% decrease from the balance at December 31, 2008 (net of write-offs) of $808,000. The decrease reflects normal collections of sales from the fourth quarter of 2008 and outstanding balances from sales in the first quarter of 2009.

Inventory increased by $366,000 when comparing the balances at June 30, 2009 and December 31, 2008, which represents a 5% increase in the inventory balance between the two periods. The increase resulted from net inventory activity including receipts totaling approximately $1,200,000, offset by a net inventory reserve decrease of approximately $135,000 and normal consumption due to sales and research activities of approximately $700,000 during the first six months of the year.

Prepaid expenses and other current assets increased by net $128,000, or 60%, to $343,000 at June 30, 2009 from the December 31, 2008 balance of $215,000. A deposit balance of $104,000 from Hyundai Heavy Industries is still outstanding from the dissolution of the Hyundai-Enova ITC joint venture for components to be delivered to Enova in the third quarter of 2009.

Property and equipment decreased by $182,000, net of depreciation and write-offs, at June 30, 2009, when compared to the December 31, 2008 balance of $1,829,000. In the first half of 2009, the Company recognized depreciation expense of $316,000 and recorded additions to fixed assets totaling $100,000, which included the purchase and retrofit of one test vehicle.

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Investment in our non-consolidated joint venture, Hyundai-Enova Innovative Technology Center (ITC) decreased to a zero balance as of June 30, 2009 from a balance of $1,352,000 at December 31, 2008. Hyundai Heavy Industries, Enova and ITC mutually agreed to the dissolution of ITC, which was completed on April 6, 2009.

Accounts payable increased in the first six months of 2009 by $257,000 to $849,000 from $592,000 at December 31, 2008. The balance included $400,000 reclassed from accrued liabilities and represents the remaining amount payable to one vendor for settlement of a dispute.

Deferred revenues increased at June 30, 2009 to $670,000 from a zero balance at the December 31, 2008. This balance is expected to be realized into revenue in the third quarter of 2009 and is predominantly associated with a prepayment on a purchase order from FAW.

Accrued payroll and related expenses decreased by $69,000, or 23%, to $226,000 at June 30, 2009 compared to a balance of $295,000 at December 31, 2008. The change between periods was due to lower headcounts.

Other accrued liabilities decreased by $770,000, or 41%, to $1,089,000 at June 30, 2009 from the balance of $1,859,000 at December 31, 2008, primarily due to payments for accrued professional and vendor services and a reclassification of approximately $400,000 to accounts payable in settlement of a vendor dispute.

Accrued interest payable was $1,033,000 at June 30, 2009, an increase of 4% from a balance of $992,000 at December 31, 2008. The increase is due to interest related to our debt instruments, primarily the secured note payable in the amount of $1,238,000 to the Credit Managers Association of California.

Our ongoing operations and anticipated growth will require us to make necessary investments in human and production 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.

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

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures which are designed to provide reasonable assurance that information required to be disclosed in the Company s periodic Securities and Exchange Commission (SEC) reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

As required by Rule 13a-15(b) under the Securities and Exchange Act of 1934, as amended, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures for the period covered by this report. Based on that evaluation, the Company s Chief Executive Officer and Chief

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Financial Officer have concluded that the Company s internal control over disclosure controls and procedures was effective as of June 30, 2009.

Management s Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) promulgated under the Exchange Act. We maintain internal control over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

During the period covered by this report, there have been no changes in the Company s internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or 15d-15 under the Securities Exchange Act of 1934 that have materially affected or are reasonably likely to materially affect the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are subject to a number of lawsuits, investigations and disputes (some of which involve substantial amounts claimed) arising out of the conduct of our business, including matters relating to commercial transactions. We recognize a liability for any contingency that is probable of occurrence and reasonably estimable. We continually assess the likelihood of adverse outcomes in these matters, as well as potential ranges of probable losses (taking into consideration any insurance recoveries), based on a careful analysis of each matter with the assistance of outside legal counsel and, if applicable, other experts.

Given the uncertainty inherent in litigation, we do not believe it is possible to develop estimates of the range of reasonably possible loss in excess of current accruals for these matters. Considering our past experience and existing accruals, we do not expect the outcome of these matters, either individually or in the aggregate, to have a material adverse effect on our consolidated financial position. Because most contingencies are resolved over long periods of time, potential liabilities are subject to change due to new developments, changes in settlement strategy or the impact of evidentiary requirements, which could cause us to pay damage awards or settlements (or become subject to equitable remedies) that could have a material adverse effect on our results of operations or operating cash flows in the periods recognized or paid.

Item 1A. Risk Factors

There have been no other material changes from the risk factors as previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Item 2. Unregistered Sales of Equity and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

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Item 6. Exhibits

a) Exhibits

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

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

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

* - Filed herewith

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SIGNATURE

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

Date: August 14, 2009

ENOVA SYSTEMS, INC. (Registrant)

/s/ Jarett Fenton

By: Jarett Fenton, Chief Financial Officer