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DIGITAL POWER CORP  
Form 10KSB  
March 29, 2005

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

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 - For the fiscal year ended December 31,  
2004

Commission File Number 1-12711

DIGITAL POWER CORPORATION  
(Name of small business issuer in its charter)

California ----- (State or other jurisdiction of Incorporation or organization)	3679 ---- (Primary Standard Industrial Classification Code)	94-1721931 ----- (I.R.S. Employer Identification No.)
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41920 Christy Street, Fremont, California 94538-3158  
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(Address of principal executive offices)

510-657-2635  
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(Issuer's Telephone Number)

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class -----	Name of Each Exchange on Which Registered -----
Common Stock	American Stock Exchange

Securities registered under Section 12(g) of the Exchange Act:

Title of Each Class  
-----  
None

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

Check if there is no disclosure of delinquent filers in response to Item 405 of  
Regulation S-B is not contained in this form, and no disclosure will be  
contained, to the best of registrant's knowledge, in definitive proxy or  
information statements incorporated by reference in Part III of this Form 10-KSB  
or any amendment to this Form 10-KSB.

Revenues for the year ended December 31, 2004, were \$8,713,000.

As of March 15, 2005, the aggregate market value of the voting common stock held  
by non-affiliates was approximately \$3,966,000 based on the closing price of  
\$1.19 per share.

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As of March 15, 2005, the number of shares of common stock outstanding was 6,161,859.

Documents Incorporated by Reference.

The information required by Items 9, 10, 11, 12 and 14 of Part III are incorporated by reference to the Company's proxy statement, which will be filed within 120 days of the issuer's year end.

As used in this annual report, the terms "we," "us," "our," the "Company," "Digital" or "Digital Power" mean Digital Power Corporation and its subsidiaries unless otherwise indicated.

With the exception of historical facts stated herein, the following discussion may contain forward-looking statements regarding events and financial trends, which may affect Digital Power's future operating results and financial position. Such statements are subject to risks and uncertainties that could cause Digital Power's actual results and financial position to differ materially from those anticipated in such forward-looking statements. Factors that could cause actual results to differ materially include, in addition to other factors identified in this report, the fact that we have experienced losses from our operations, that the power supply industry, in general, has experienced an economic down turn and our dependence on our manufacturing subcontractor primarily in China, all of which factors are set forth in more detail in the sections entitled "Certain Considerations" and "Management's Discussion and Analysis or Plan of Operation" herein. Readers of this report are cautioned not to put undue reliance on "forward looking" statements which are, by their nature, uncertain as reliable indicators of future performance. Digital Power disclaims any intent or obligation to publicly update these "forward looking" statements, whether as a result of new information, future events, or otherwise.

### PART I.

#### ITEM 1. DESCRIPTION OF BUSINESS

##### General

Digital Power Corporation designs, develops, manufactures, markets, and sells switching power supplies to industrial, telecommunication, data communication, medical and military industries. We are a California corporation originally formed in 1969. Our corporate office, which contains our administrative, sales, and engineering functions, is located in Fremont, California. In addition, the Company has a wholly-owned subsidiary, Digital Power Limited ("DPL"), located in Salisbury, England which designs, manufactures and sells products for the European market place including power conversion products for naval and military applications and DC/AC inverters for the telecommunications industry under the label Gresham Power Electronics.

We primarily sell our switching power supplies to industrial, telecommunication, data communication, medical and military industries both in North America and Europe. These industries have experienced pricing pressure that has adversely affected our operations and financial condition. As a result, we incurred an operating loss during the year ended December 31, 2004. The Company has the option of purchasing products from a Mexican subcontractor or from a Chinese subcontractor at lower prices with longer lead time. For the products produced in Mexico, we purchase the raw material and ship to our third party manufacturer who manufactures our products according to our

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specifications. Subsequent to the balance sheet date, we have ended our relationship with the Mexican contract manufacturer.

Power supplies are critical components of electronic equipment that supply, convert, distribute, and regulate electrical power. The various subsystems within electronic equipment require a steady supply of direct current (DC) electrical power, usually at different voltage levels from the other subsystems within the equipment. In addition, the electronic components and subsystems require protection from the harmful surges and drops in electrical power that commonly occur over power lines.

Power supplies satisfy these issues of allocation and protection by (i) converting alternating current (AC) electricity into DC; (ii) by dividing a single input voltage into distinct and isolated output voltages; and (iii) by regulating and maintaining such output voltages within a narrow range of values.

Products which convert AC from a primary power source into DC are generally referred to as "power supplies". Products which convert one level of DC voltage into a higher or lower level of DC voltage are generally referred to as "DC/DC

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converters". "Switching" power supplies are distinguished from "linear" power supplies by the manner and efficiency with which the power supplies "steps down" voltage levels. A linear power supply converts an unregulated DC voltage to a lower regulated voltage by "throwing away" the difference between the two voltages as heat. Consequently, the linear power supply is inherently inefficient-typically only 45% efficient for a 5V output regulator. By contrast, a switching power supply converts an unregulated DC voltage to a lower regulated voltage by storing the difference in a magnetic field. When the magnetic field grows to a pre-determined level, the unregulated DC is switched off and the output power is provided by the energy stored in the magnetic field. When the field is sufficiently depleted, the unregulated DC is switched on again to deliver power to the output while the excess voltage is again stored in the magnetic field. As a result, the switching power supply is more efficient-typically 75% efficient for a 5V output regulator.

One of the great advantages of switching power supplies, in addition to the high efficiency, is their high power density, or power-to-volume ratio. This density is the result of the reduction in the size of the various components. Our switching power supply products have a high power density making them smaller than those many of our competitors.

Another advantage of our power supply products is the flexibility of design. We have designed the base model power supply products so that they can be quickly and inexpensively modified and adapted to the specific power supply needs of any OEM. This "flexibility" approach has allowed us to provide samples of modified power supplies to OEM customers in only a few days after initial consultation, an important capability given the emphasis placed by OEMs on "time to market". This "flexibility" approach also results in very low non-recurring engineering (NRE) expenses. Because of reduced NRE expenses, we do not generally charge our OEM customers for NRE related to tailoring a power supply to a customer's specific requirements. This gives us an advantage over our competitors, many of whom do charge their customers for NRE expenses. Our marketing strategy is to exploit this combination of high power density, design flexibility, and short time-to-market to win an increasing share of the power supply market.

In addition to the line of proprietary products offered, and in response to requests from OEMs, we also provide "value-added services". The term "value-added services" refers to our incorporation of an OEM's selected

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electronic components, enclosures, and cable assemblies with our power supply products to produce a power subassembly that is compatible with the OEM's own equipment and specifically tailored to meet the OEM's needs. We purchase parts and components that the OEM itself would otherwise attach to or integrate with our power supply, and we provide the OEM with that integration and installation service, thus saving the OEM time and money. We believe that this value-added service is well-suited to those OEMs who wish to reduce their vendor base and minimize their investment in manufacturing which leads to increased fixed costs. Based on the value-added services, the OEMs do not need to build assembly facilities to manufacture their own power subassemblies and thus are not required to purchase individual parts from many vendors.

We made progress in penetrating the domestic military sector and, as a result of our strategic collaboration with Telkoo Power Ltd. ("Telkoo") we have been awarded an initial \$1.6 million contract to provide sophisticated mil-spec power supplies for a military avionics application. The majority of this revenue will be recognized in 2005.

Telkoo Power Ltd.

Telkoo is primarily engaged in developing, marketing and selling power supplies and power systems for the telecommunication equipment industry and military. Consistent with our total cost reduction efforts, and taking advantage of Telkoo's strong engineering team, we have and will continue to utilize Telkoo to assist us in new product development. Further, during the year ended December 31, 2004, we made progress in penetrating the United States and European markets with Telkoo's products. This effort generated sales of approximately 30.72% of our revenues for 2004. We intend to continue to sell Telkoo's products in the future to supplement our line of products.

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Digital Power Limited

Digital Power Limited, headquartered in Salisbury, England, designs, manufactures, and distributes switching power supplies, uninterruptible power supplies, and power conversion and distribution equipment frequency converters for the commercial and military markets under the name Gresham Power Electronics. Uninterruptible power supplies (UPS) are devices that are inserted between a primary power source and the primary power input of the electronic equipment to be protected for the purpose of eliminating the effects of transient anomalies or temporary outages. A UPS consists of an inverter that is powered by a battery that is kept trickle-charged by rectified AC from an incoming power line. In the event of a power interruption, the battery takes over without the loss of even a fraction of a cycle in the AC output of the UPS. Frequency converters manufactured by DPL are used to convert a warship's generated 60 cycle electricity supply to 400 cycles. This 400 cycle supply is used to power critical equipment such as the ship's gyro, compass and weapons systems. DPL also designs and manufactures Transformer Rectifiers for Naval use. Typically these provide battery supported back-up for critical DC systems such as machinery and communications. In addition higher power rectifiers are used for helicopters on naval vessels. DPL and the Gresham Power Electronics products adds diversity to our product line, provides greater access to the United Kingdom and European markets and strengthens our engineering and technical resources. For the year ended December 31, 2004, DPL contributed approximately 56% to our gross revenues.

The Market

Geographically, we primarily serve the North American power electronics market with individual AC/DC power supplies and DC/DC converters ranging from 50

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watts to 800 watts of total output power. DPL serves the United Kingdom and the European marketplace with AC/DC power supplies, uninterruptible power supplies, and frequency inverters.

### Customers

Our products are sold domestically and in North America through a network of manufacturers' representatives and distributors. Our customers can generally be grouped into five broad industries, consisting of the industrial, telecommunication, data communication, medical and military. We have a current base of approximately 400 active customers, some of which are sold through our distributors.

Gresham Power Electronic products are sold primarily in the UK and in Europe. The Company has been particularly successful in securing an export market in Spain for its defense products. In the UK, our main customers include the UK Ministry of Defense, BAE Systems, Bacock Defense and Marshalls plc. In Mainland Europe, we sell directly to IZAR in Spain and Emerson in Sweden. We sell power supplies through European distributors with our greatest strength in Germany and Scandinavia.

### Strategy

Our strategy is to be the supplier of choice to OEMs requiring high-quality power solutions where size, rapid modification, and time-to-market are critical to business success. Target market segments include the industrial, telecommunication, data communication, medical and military industries. While many of these segments would be characterized as computer-related, we do not participate in the personal computer (PC) power supply market because of the low margins arising out of the high volume and extremely competitive nature of that market.

We intend to continue our sales primarily to existing customers while simultaneously targeting sales to new customers. We believe that our "flexibility" concept allows customers a more effective choice between our products and products offered by other power supply competitors. Our "flexibility" series is designed around a standardized power platform, but

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allows the customer to specify output voltages tailored to its exact requirements within specific parameters. Furthermore, OEMs are seeking power supplies with greater power density and higher efficiency. Digital Power's strategy in responding to this demand has been to offer increasingly smaller power supply units or packages. OEMs have typically had to settle for a standard power supply product with output voltages and other features predetermined by the manufacturer. Alternatively, if the OEM's product required a different set of power supply parameters, the OEM was forced to design this modification in-house, or pay a power supply manufacturer for a custom product. Because custom-designed power supplies are development-intensive and require a great deal of time to design, develop, and manufacture, typically only OEMs with significant volume requirements can economically justify the expense and delay associated with their production. Furthermore, since virtually every power conversion product intended for use in commercial applications requires certain independent safety agency testing at considerable expense, such as by Underwriters Laboratories, an additional barrier is presented to the smaller OEM. By offering OEM customers a new choice with Digital Power's "flexibility" series, we believe we have an advantage over our competitors.

### Product Strategy and Products

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We have ten series of base designs from which thousands of individual models can be produced. Each series has its own printed circuit board (PCB) layout that is common to all models within the series regardless of the number of output voltages (typically one to four) or the rating of the individual output voltages. A broad range of output ratings, from 2.0 volts to 48 volts, can be produced by simply changing the power transformer construction and a small number of output components. Designers of electronic systems can determine their total power requirements only after they have designed the system's electronic circuitry and selected the components to be used in the system. Because the designer has a finite amount of space for the system and may be under competitive pressure to further reduce its size, a burden is placed on the power supply manufacturer to maximize the power density of the power supply. A typical power supply consists of a PCB, electronic components, a power transformer and other electromagnetic components, and a sheet metal chassis. The larger components are typically installed on the PCB by means of pin-through-hole assembly where the components are inserted into pre-drilled holes and soldered to electrical circuits on the PCB. Other components can be attached to the PCB by surface mount interconnection technology (SMT) which allows for a reduction in board size because the holes are eliminated and components can be placed on both sides of the board. Our US100 series is an example of a product using this manufacturing technology.

Digital Power's "flexibility" concept applies to all of our US, UP/SP, DP and UPF product series. A common printed circuit board is shared by each model in a particular family, resulting in a reduction in parts inventory while allowing for rapid modifiability into thousands of output combinations. The following is a description of our primary products.

Four of our product offerings resulting from our strategic relationship with Telkoor are the eF's series, CPCI's series, Strong Box serial and custom products.

The new 1.8KW Strongbox(R) is a single output front end with I2C databus. It features 3 x 600 watt cassettes. The Strongbox is available in 24V, and 48V outputs with active power factor correction.

The US50 series of power supplies consists of compact, economical, high efficiency, open frame switchers that deliver up to 50 watts of continuous power, or 60 watts of peak power, from one to four outputs. The 90-264 VAC universal input allows them to be used worldwide without jumper selection. Flexibility options include power good signal, an isolated V4 output, and UL544 (2nd Ed.) safety approval. All US50 series units are also available in 24VDC, or 48VDC inputs. This optional DC input unit (DP50 series) maintains the same pin-out, size, and mounting as the US50 series.

The US70 series of power supplies is similar to the US50 series, a compact, economical, highly efficient, open frame switcher that delivers up to 65 watts with a 70 watt peak. This unit is offered with one to four outputs, a universal input rated from 90 to 264 VAC and is only slightly larger than the US50 series.

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The US70 series is differentiated from competitive offerings by virtue of its smaller size, providing up to four outputs while competitors typically are limited to three outputs. Flexibility options include cover, power good signal, an isolated V4 output, and UL544 (2nd Ed.) medical safety approval. The DP70 is the same as the US70 except the input is 48 volts DC. We also offer 24VDC input on this series where the model series changes to a DM. This type of product is ideal for low profile systems, with the power supply measuring 3.2" x 5" x 1.5".

The US100/DP100 was the industry's smallest 100 watt switcher when

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originally introduced. Measuring only 5" x 3.3" x 1.5", this series delivers up to 100 watts of continuous power, or 120 watt peak power, from one to four outputs. The 90-264VAC universal input allows them to be used worldwide. This product is ideal in applications where OEMs have upgraded their systems, requiring an additional 30-40 watts of output power, but being unable to accommodate a larger unit. The US100 fits in the same form factor and does not require any tooling or mechanical changes by the OEM. Flexibility options include a cover and adjustable post regulators on V3 and/or V4 outputs and UL2601-1 (2nd Ed.) medical safety approval. Fully customized models are also available. All US100 series units are also available with 12VDC, 24VDC, or 48 VDC inputs. This optional DC input unit (DP100) maintains the same pin-out, size, and mounting as the US100 series.

The US250 series consists of economical, high efficiency, open frame switchers that deliver up to 250 watts of continuous power, or 300 watts of peak power, from one to four outputs. The 115/230VAC auto-selectable input allows them to be used worldwide. Flexibility options include cover, power fail/power good signal, enable/inhibit, and an isolated V3 output. All US250 series units are also available with 12VDC, 24VDC, or 48VDC inputs. This optional DC input unit (DP250) maintains the same pin-out, size, and mounting as the US250 series.

The UP300 series consists of economical, high efficiency, open frame switchers that deliver up to 300 watts of continuous, or 325 watts of peak power, from one or two outputs. The 115/230VAC auto-selectable input allows them to be used worldwide. On-board EMI filtering is a standard feature. Flexibility options include a cover, power fail/power good signal, and an isolated 2nd output. This product can be used in network switching systems or other electronic systems where a lot of single output current, such as 5, 12, 24, or 48 volt current might be required.

The UPF150/DP150 series is an open-frame switcher that delivers up to 150 watts of continuous power from one to four outputs. In response to market condition for more functionality, the UPF 150 has both power factor correction and a Class B EMI filter as standard features. All UPF150 series units are available with 24VDC, or 48VDC inputs. This optional DC input unit (DP150) maintains the same pin-out, size, and mounting as the UPF150 series.

The UPF 300 watts delivers up to 300 watts from one or two outputs and also includes power factor correction and measures 8" x 4.5" x 2".

### Gresham Products

Gresham designs and manufactures a wide range of products for Naval applications. These include:

Static Frequency Converters - typically converts Ship's supply from 50/60Hz to 400Hz for gyros and weapons systems. Power range is from 1kVA to 35kVA.

DC Systems - converts main Ship's supply to 24VDC. These systems normally supported by battery back up provide the vessel's emergency DC supplies for machinery, communications and other essential services.

Transformer Rectifiers 28V to 400A. Ratings of 10 and 15kVA provide DC power to enable the ship to start and service helicopters. Gresham's TRUs are in service with a number of Navies including the Royal Navy and are designated by Westland Helicopters in support of Super Lynx.

Inverters - 1kVA to 3.6 kVA typically convert DC to 440V 3phase 60 Hz for communications and emergency services.

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Circuit breaker monitoring and controls - modular system of controls for main circuit breakers based upon digital circuitry. Modules available include over current, short circuit, low voltage, over and under frequency and an indicator module. Many are used in submarine service.

Intelligent switchmode DC/DC power supplies in support of inboard submarine sonar.

Filter boxes for secure communications.

Navigation and signal panels - for the control and dimming of ship's external navigation lights.

Gresham also manufactures a range of commercial inverters of its own design for telecoms applications. Rated at 250VA, 500VA and 1kVA these convert either 24V or 48V DC to AC.

In addition to Digital Power and Telkooor products, Gresham distributes a wide range of commercial uninterruptible power supplies. Power ratings range from 500VA to 6kVA in a modular configurable range. The Company also provides turnkey high power solutions for major business users. Typically configured with generators for the support of substantial institutional systems, power ratings can extend to 300kVA

### Manufacturing Strategy

Consistent with our product flexibility strategy, we aim to maintain a high degree of flexibility in our manufacturing strategy through the use of strategically focused contract manufactures. It is our belief that strategically focused contract manufacturers will meet our near term cost, delivery and quality goals while providing synergistic concepts. In addition, we believe these relationships will eventually give us access to new markets and cross licensing arrangements that may be beneficial. The competitive nature of the power supply industry has also placed continual downward pressure on selling prices. In order to achieve our low cost manufacturing goals with labor intensive product, we also plan on continually increasing our supply base through the use of contract manufacturers in the Far East. At present our principle source in the Far East is Winco Power. Presently, we are in negotiation with a second contract manufacturer in China. We also subcontract to a contract manufacturer located in Guadalajara, Mexico on a project to project basis. Subsequent to the balance sheet date, we have ended our relationship with the Mexican contract manufacturer and we expect all projects to cease during the second quarter of 2005.

We have contract manufacturing relationships with Winco Power Technology to manufacture our products at facilities located in China on a turnkey basis. Purchases from Winco are made pursuant to purchase orders. For the year ended December 31, 2004, Digital Power purchased approximately 24% of its power supply requirements through Winco Power Technology. Our products are meeting the certification standards according to independent safety agency requirements. We are in negotiation with a second contract manufacturer in China.

### Digital Power Limited Manufacturing

Digital Power Limited operates from a 25,000 sq. ft leased facility located in Salisbury U.K. The equipment designed and manufactured in Salisbury is different from the power supplies produced in Mexico and China. Full assembly, test and quality assurance takes place in house.

Sales and service support staff for the European network of distributors for Digital Power products are located within the building together with other



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functions such as Engineering and Administration.

### Sales, Marketing and Customers

Digital Power markets its products through a network of independent manufacturer's representatives. Each representative organization is responsible

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for managing sales in a particular geographic territory. Generally, the representative has exclusive access to all potential customers in the assigned territory and is compensated by commissions at 5% of net sales after the product is shipped, received, and paid for by the customer. Typically, either we or the representative organization may terminate the agreement with 30 day's written notice.

In certain territories, we have entered into agreements with distributors who buy and resell our products. For the fiscal years ended December 31, 2004 and 2003, domestic distributor sales accounted for 20.43% and 38.60%, respectively, of our total sales. Over this same period, one distributor accounted for 16.85%, and 17.90%, respectively, of total sales. In general, the agreements with distributors are subject to annual renewal and may be terminated upon 90 days' written notice. Although these agreements may be terminated by either party, in the event a distributor decides to terminate its agreement with us, we believe that we would be able to continue the sale of our products through direct sales to the customers of the distributor. Generally, the Company does not grant a right of return. Revenues subject to certain stock rotation are deferred until the products are sold to the end customer or until the rotation rights expire. Certain distributors are allowed, in the sixth month after the initial stock purchase, to rotate stock that has not been sold for other products. This may be repeated each sixth month thereafter for 18 months, at no more than 25% of the distributor's purchase during the previous six months. For the past three years, stock rotations have not exceeded one percent of total sales.

Our promotional efforts to date have included product data sheets, trade shows and Internet Web sites. Our future promotional activities will likely include space advertising in industry-specific publications, application notes and enhancements to our existing Web sites.

Our products are warranted to be free of defects for approximately twelve months from date of shipment. As of December 31, 2004 and 2003, our warranty reserve was \$116,000 and \$111,000, respectively.

### Competition

The merchant power supply manufacturing industry is highly fragmented and characterized by intense competition. Our competition includes hundreds of companies located throughout the world, some of whom have advantages over us in terms of labor and component costs, and some of who may offer products comparable in quality to ours. Many of our competitors, including Power One, Artesyn Technologies, Inc., ASTEC America, Lambda Electronics, and Meanwell Power Supplies have substantially greater fiscal and marketing resources and geographic presence than we do. If we are successful in increasing our revenues, competitors may notice and increase competition for our customers. We also face competition from current and prospective customers who may decide to design and manufacture internally the power supplies needed for their products. Furthermore, certain larger OEMs tend to contract only with larger power supply manufacturers. This factor could become more problematic to us if consolidation trends in the electronics industry continue and some of the OEMs to whom we sell our products are acquired by larger OEMs. To remain competitive, management

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believes that we must continue to compete favorably on the basis of value by providing reliable manufacturing, offering customer service and design engineering services, continuously improving quality and reliability levels, and offering flexible and reliable delivery schedules. We believe we have a competitive position with our targeted customers who need a high-quality, compact product which can be readily modified to meet the customer's unique requirements. However, there can be no assurance that we will continue to compete successfully in the power supply market.

### Engineering and Product Development

Our engineering and product development efforts are primarily directed toward modification of our standard power supply to provide a broad array of individual models. Improvements are constantly sought in power density, modifiability, and efficiency, while we attempt to anticipate changing market demands for increased functionality, such as PFC and improved EMI filtering.

Historically, the Company has utilized consultants and contract engineering for the majority of its new product developments, supported by the internal engineering staff for product engineering. The Company intends to continue this

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strategy for engineering and development. Further, as a result of the strategic relationship with Telkoor, the Company utilizes Telkoor's engineering team in Israel to assist it in new product development. If the Company identifies a potential new product for development, it will cooperate with Telkoor to design and develop the product.

### Employees

As of December 31, 2004, we had 37 employees located in the United States and the United Kingdom.

### Foreign Currency Fluctuations

Gresham Power conducts its financial operation using the United Kingdom pound sterling. Therefore, we are subject to monetary fluctuations between the U.S. dollar and United Kingdom pound sterling. For the years ended December 31, 2004 and 2003 we recorded foreign currency translation adjustments of \$81,000 and \$146,000 respectively.

### Raw Materials

The raw materials for power supplies principally consist of electronic components. These raw materials are available from a variety of sources and we are not dependent on any one supplier. We generally purchase components based on orders received or forecast to minimize our risk of unusable inventory. To the extent necessary we may order materials prior to orders to obtain shorter lead times and achieve quantity discounts following a risk assessment.

We expect our purchase of raw material to decrease as we move to turnkey contract manufacturers in the Far East.

### Intellectual Property

We rely upon a combination of trade secrets, industry expertise, confidential procedures and contractual provisions to protect our intellectual property. We believe that because our products are continually updated and revised, obtaining patents would be costly and not beneficial.

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On July 8, 2004, our trademark, "DP Digital Power - Powering our technologies," was registered with the United States Patent and Trademark Office.

### ITEM 2. DESCRIPTION OF PROPERTY.

Our headquarters are located in approximately 9,500 square feet of leased office engineering and development space in Fremont, California. For the year ended December 31, 2004, we paid \$8,550 per month for rent. On October 1, 2005 our rent will increase to \$9,025 per month till September 30, 2006. From October 1, 2006 to September 30, 2007, our rent will be \$9,500 per month. During 2002, we issued to the landlord warrants to purchase 10,000 shares of Common Stock at an exercise price of \$1.00 per shares expiring in September 2013.

DPL leases approximately 25,000 square feet for its location in Salisbury, England. DPL pays rent of approximately \$15,000 per month, and the lease expires on September 26, 2008. We believe that our existing facilities are adequate for the foreseeable future and have no plans to expand them.

### ITEM 3. LEGAL PROCEEDINGS.

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. ("Tek-Tron") in state court of Pennsylvania, specifically, the

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Court of Common Pleas of Bucks County, at Case No. 0302116-24-1. Tek-Tron was seeking damages of approximately \$300,000 for breach of contract and conversion of parts and infrastructure owned by Tek-Tron located in the Company's former subsidiary, Poder Digital S.A's, Mexico manufacturing plant. In April 2004, the Company signed a settlement agreement with Tek-Tron according to which the Company agreed to pay \$90,000 in installments and return certain disputed inventory for a full release. As of December 31, 2004, the Company paid the full \$90,000. The settlement agreement allows Tek-Tron to seek arbitration limited to the sum of \$50,000 in case the parties do not agree on a resolution regarding the returned inventory. Tek-Tron has notified the Company it believes that the disputed inventory contains missing labeling and inspection reports. The Company continues to work toward reaching a resolution over the returned property for which the Company' has a maximum liability of \$50,000 under the settlement agreement. The Company's management and its litigation counsel are unable to assess the outcome of such arbitration proceeding.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

## PART II

### ITEM 5. MARKET FOR COMMON EQUITY AND RELATED SHAREHOLDER MATTERS.

#### (a) Comparative Market Prices

Our common share is listed and traded on the American Stock Exchange ("AMEX") under the symbol DPW. The following tables set forth the high and low closing sale prices, as reported by AMEX, for our common share for the prior two fiscal years.

Quarter Ended	High	Low
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12/31/2004	\$1.25	\$1.23

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9/30/2004	0.82	0.76
6/30/2004	1.35	1.20
3/31/2004	1.15	1.10
12/31/2003	\$0.85	\$0.84
9/30/2003	0.78	0.75
6/30/2003	0.78	0.78
3/31/2003	0.57	0.55

### (b) Holders

As of March 15, 2005, there were 6,161,859 shares of our common shares outstanding, held by approximately 96 registered holders, not including holders whose shares of common stock are held in street name.

### (c) Dividends

We have not declared or paid any cash dividends since our inception and we do not intend to pay any cash dividends in the foreseeable future. The declaration of dividends in the future, if any, will be at the discretion of the Board of Directors and will depend upon our earnings, capital requirements and financial position.

### (d) Recent Sales of Unregistered Securities

In January 2005, the Company entered into a convertible note agreement with Telkoor, according to which Telkoor loaned a \$ 250,000 interest free convertible

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note to be paid on the tenth business day after the Company announced its financial results for 2005. The note may be converted into Common stock at a rate of \$ 1.06 per share. Automatic conversion shall occur if the Company meets its set budget for 2005.

The sale and issuance of the convertible note was made by us in reliance upon the exemptions from registration provided under Section 4(2) and 4(6) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D, promulgated by the SEC under federal securities laws and comparable exemptions for sales to "accredited" investors under state securities laws. The offers and sales were made to accredited investors as defined in Rule 501(a) under the Securities Act, no general solicitation was made by us or any person acting on our behalf; the securities sold were subject to transfer restrictions, and the certificates for those shares contained an appropriate legend stating that they had not been registered under the Securities Act and may not be offered or sold absent registration or pursuant to an exemption there from.

## ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

### General

We are engaged in the business of designing, developing, manufacturing, marketing and selling switching power supplies to the industrial, telecommunication, data communication, medical and military industries. Revenues are generated from sales to distributors, OEMs in North America, Europe and the United Kingdom.

During the year ended December 31, 2004, the Company's products were received well in the market place. We have continued our promotional efforts to increase sales to existing and new customers and continue our strategy to move

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the manufacture of our products to the Far East. Until revenues increase to a sufficient amount to offset our expenses, we anticipate that we will continue to experience net losses. We believe that our cash will be sufficient to fund those losses for at least 12 months.

During 2004, the Company issued 511,261 Common shares to Telkoo in consideration of \$ 493,000 net of issuance expenses at the price of the average closing price of the Company's share of common stock during the twenty trading days preceding the closing date.

In June 2004, the Company issued 204,918 Common shares to a new investor, in consideration of \$ 250,000 at the price of the average closing price of the Company's share of common stock during the twenty trading days preceding the closing date.

### Results of Operations

The table below sets forth certain statements of operations data as a percentage of revenues for the years ended December 31, 2004 and 2003:

	Years Ended December 31,	
	2004	2003
Revenues	100.00%	100.00%
Cost of Revenues	76.23	72.30
Write-off of excess inventory	2.50	0.63
	21.27	27.07
Gross profit		
Engineering and product development	7.16	7.57
Sales and marketing	15.15	14.93
General and administrative	13.24	19.03
	35.55	41.53
Total operating expenses		
Operating loss	(14.28)	(14.46)
Financial income and other expense	0.51	0.34
	(13.77)	(14.12)
Loss before tax benefit		
Tax benefit	0.28	1.05
	(13.49)%	(13.07)%
Net loss	(13.49)%	(13.07)%

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The following discussion and analysis should be read in connection with the consolidated financial statements and the notes thereto and other financial information included elsewhere in this report. We prepared the financial statements in accordance with generally accepted accounting principles which require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Year Ended December 31, 2004 compared to Year Ended December 31, 2003

### Revenues

For the year ended December 31, 2004, revenues increased by 18.24% to \$8,713,000 from \$7,369,000 for the year ended December 31, 2003. The increase in revenue is mainly due to our newer products developed through Telkooor being received well in the market place.

Revenues from the domestic operation of DPC increased 12.79% to \$3,854,000 for the year ended December 31, 2004, from \$3,417,000 for the year ended December 31, 2003. Revenues from the Company's European operations of DPL increased 22.95% to \$4,859,000 for the year ended December 31, 2004, from \$3,952,000 for the year ended December 31, 2003. The increase in revenues for the year ended December 31, 2004 from December 2003 is due to our products being received well in the market place.

### Gross Margins

Gross margins were 21.27% for the year ended December 31, 2004, compared to 27.07% for the year ended December 31, 2003. The decrease in our gross margins can be primarily attributed to the shifting in product mix and one time inventory write-offs in the total amount of \$218,000 related mainly to obsolete raw material and slow moving inventory in DPL.

### Engineering and Product Development

Engineering and product development expenses were 7.16% of revenues for the year ended December 31, 2004, compared to 7.57% for the year ended December 31, 2003. Actual dollar expenditures increased by \$66,000 from 2003 to 2004 partly due to the utilization of subcontractors.

### Selling and Marketing

Selling and marketing expenses were 15.15% of revenues for the year ended December 31, 2004, compared to 14.93% for the year ended December 31, 2003.

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Actual dollar expenditures increased by \$220,000 from 2003 to 2004. The increase in sales and marketing was primarily due to the hiring of a sales person, travel and advertising expenses as part of our efforts to increase sales.

### General and Administrative

General and administrative expenses were 13.24% of revenues for the year ended December 31, 2004, compared to 19.03% for the year ended December 31, 2003. The decrease of \$248,000 in general and administrative expenses from 2003 to 2004 is mainly due to reductions in the personnel hours spent on administrative duties. In 2003, general and administrative expenses included accrued litigation expenses of \$102,000.

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### Financial Income and Other Expenses

Financial income, net of interest expense, was \$45,000 for the year ended December 31, 2004 compared to an income of \$25,000 for the year ended December 31, 2003. The increase in the financial income from 2003 to 2004 is from the Company's United Kingdom's operations of DPL

### Loss before Tax benefit

For the year ended December 31, 2004, we had a loss before tax benefit of \$1,200,000 compared to a loss of \$1,040,000 for the year ended December 31, 2003. The loss increase is mainly due to one time inventory write-offs in the total amount of \$218,000 related to obsolete raw material and slow moving inventory in DPL.

### Tax Benefit

For the year ended December 31, 2004, the Company recorded a tax benefit of \$25,000 compared to a tax benefit of \$77,000 for the year ended December 31, 2003. The tax benefit for the year 2004 and 2003 are from the UK operations.

As of December 31, 2004, the Company had approximately \$4,780,000 in federal net operating loss carryforward for income tax purposes, which can be carried forward and offset against taxable income for 20 years and expire in 2022 - 2024.

### Net Loss and Net Income

Net loss for the year ended December 31, 2004, was \$1,175,000 compared to a net loss of \$963,000 for the year ended December 31, 2003. The net loss can be attributed mainly due to the decrease in gross margins and one time inventory write-offs in the amount of \$218,000. We plan on continually increasing our supply base through the use of contract manufacturers in the Far East in order to reduce our cost.

### Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States require management to make estimates and assumptions that affect the reported assets, liabilities, sales and expenses in the accompanying financial statements. Critical accounting policies are those that require the most subjective and complex judgments, often employing the use of estimates about the effect of matters that are inherently uncertain. The following are considered our most critical accounting policies that, under different conditions or using different assumption or estimates, could show materially different results on our financial condition and results of operations.

### Revenue Recognition

The Company's revenue recognition policy for product revenue is such that

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revenue is recognized when the risks and rewards of ownership pass, which is primarily upon delivery of goods to customers (see Note 2h to the Consolidated Financial Statements).

### Inventory Obsolescence Accruals

The Company writes down its inventory for estimated obsolescence or

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unmarketable inventory to the estimated net realizable value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

### Allowance for Doubtful Accounts

Our accounts receivable are derived from revenue earned from customers located in the United States and the United Kingdom. We perform ongoing credit evaluations of our customers' financial condition and currently require no collateral from our customers. An allowance for doubtful accounts for estimated losses is maintained in anticipation of the inability or unwillingness of customers to make required payments. When we become aware that a specific customer is unable to meet its financial obligations, such as the result of bankruptcy or deterioration in the customer's operating results or financial position, we record a specific allowance to reflect the level of credit risk in the customer's outstanding receivable balance. We are not able to predict changes in the financial condition of customers, and if the condition or circumstances of our customers deteriorates, estimates of the recoverability of trade receivables could be materially affected and we may be required to record additional allowances. Alternatively, if our estimates are determined to be greater than the actual amounts necessary, we may reverse a portion of such allowance in future periods based on actual collection experience.

### Other Accrued Liabilities

The Company also maintains other accrued liabilities. These accruals are based on a variety of factors including past experience and various actuarial assumptions and, in many cases, require estimates of events not yet reported to the Company. If future experience differs from these estimates, operating results in future periods would be impacted.

### Liquidity and Capital Resources

On December 31, 2004, we had cash, cash equivalents and restricted cash of \$1,554,000 and working capital of \$2,437,000. This compares to cash, cash equivalents and restricted cash of \$1,346,000 and working capital of \$2,686,000 at December 31, 2003.

Net cash used in operating activities was \$541,000 for the year ended December 31, 2004, compared to cash used in operating activities of \$197,000 for the year ended December 31, 2003.

Net cash provided by investing activities was \$38,000 for the year ended December 31, 2004, compared to cash provided in investing activities of \$262,000 for the year ended December 31, 2003.

Net cash provided by financing activities was \$765,000 for the year ended December 31, 2004, compared to net cash provided by financing activities of \$331,000 for the year ended December 31, 2003.

In January 2005, the Company entered into a convertible note agreement with Telkoor, according to which Telkoor loaned a \$250,000 interest free convertible note to be paid on the tenth business day after the Company announced its financial results for 2005. The note may be converted into Common stock at a rate of \$1.06 per share. Automatic conversion shall occur if the Company meets its set budget for 2005.

Since May 2003, the Company has a line of credit from Silicon Valley Bank



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("SVB"). The Company can borrow up to \$ 1,200,000 at SVB's prime rate plus 1.75% (totaling 5.25% at December 31, 2004). In order to use the line of credit, the Company is required to maintain certain ratios and be in compliance with other covenants. Interest only is payable on a monthly basis. The maturity date of the line of credit is August 30, 2005. As of December 31, 2004, the Company had not yet utilized its line of credit.

We do not believe that our sales are seasonal. Further, we do not believe that inflation at the current and projected rates will have a material adverse impact on our operations. The Company believes it has adequate resources at this time to continue its promotional efforts to increase sales in the electronic industry market. However, if the Company does not meet those goals, it may have to raise money through debts or equity, which may dilute the shareholder equity.

### Management

There is currently a dispute between certain shareholders and managers of Telkooor, which is subject to litigation in Israel. Two of the members of our Board of Directors and the two members that comprise the Board of Directors of Digital Power Limited are involved in this dispute. Although, the Company does not believe the dispute has seriously effected the day-to-day operations of the Company, it may however have an adverse impact on certain decision making in the Company.

### RISK FACTORS

In addition to the other information presented in this report, the following should be considered carefully in evaluating us and our business. This report contains various forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed below and elsewhere in this report.

We experienced an operating loss during the year ended December 31, 2004 and anticipate that losses will continue in the near future.

For the year ended December 31, 2004, we incurred an operating loss of \$1,245,000. Although we have actively taken steps to reduce our costs, we will incur losses until we increase revenues through the sale of current products and decrease manufacturing costs through a greater utilization of Far East contract manufacturers.

We are dependent on a limited number of customers.

Traditionally, we have relied on a limited number of customers for growth in sales. It cannot be assured that we will be able to retain current customers and the loss of any major OEM customer may have an adverse effect on our revenues.

We are dependant on Telecommunication and other electronic equipment industries.

Substantially all of our existing customers are in the telecommunication and other electronic equipment industries and they manufacture products that are subject to rapid technological change, obsolescence and large fluctuations in demand. These industries are further characterized by intense competition. The OEMs serving these markets are pressured for increased product performance and lower product prices. OEMs, in turn, make similar demands on their suppliers, such as us, for increased product performance and lower prices. The telecommunication industry is inherently volatile. Recently, certain segments of the telecommunication and other electronic industries have experienced a

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significant softening in product demand. Such lower demand may affect our customers, in which case the demand for our products may decline and our growth could be adversely affected.

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We are dependent on the performance of our subcontract manufacturers.

Since we do not own significant manufacturing facilities, we must rely on our subcontractors' abilities to purchase components, staff their operation, maintain high volume and high quality processes and remain financially solvent.

Conditions in Israel may limit our ability to receive and sell products. This could decrease our revenues.

Telkoor's principal offices, research and development and manufacturing facilities are located in Israel. Political, economic and military conditions in Israel directly affect their operations. We could be adversely affected by any major hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners, a significant increase in inflation, or a significant downturn in the economic or financial conditions of Israel. Restrictive laws or policies directed towards Israel or Israeli businesses could adversely affect us.

We are dependant upon key personnel.

Our performance is substantially dependent on the performance of its executive officers and key personnel and on our ability to retain and motivate such personnel. The loss of any of our key personnel could have a material adverse effect on our business, financial condition and operating results.

We are dependant on suppliers.

We rely on, and will continue to rely on, outside parties to manufacture parts, components and equipment. We cannot assure you that these suppliers will be able to meet our needs in a satisfactory and timely manner or that we will be able to obtain additional suppliers when and if necessary. A significant price increase, a quality control problem, an interruption in supply or other difficulties with third party manufacturers could have a material and adverse effect on our ability to successfully provide our products. Further, the failure of third parties to deliver the products, components, necessary parts or equipment on schedule, or the failure of third parties to perform at expected levels, could delay our delivery of power supply products.

Our products are not protected by patents.

Our products are not subject to any U.S. or foreign patents. We believe that because our products are continually updated and revised, obtaining patents would be costly and not beneficial. Therefore, we cannot guarantee that other competitors or former employees will make use of and develop proprietary information on which we rely.

Our common stock price is volatile.

Our common stock is listed on the American Stock Exchange and is thinly traded. In the past, our trading price has fluctuated widely, depending on many factors that may have little to do with our operations or business prospects. Further, the exercise of outstanding options and warrants may adversely affect our stock price and your percentage of ownership. As of December 31, 2004, the Company has employees options to purchase 1,290,425 shares of common stock, with a weighted average exercise price of \$1.28 exercisable at prices ranging from

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\$0.48 to \$2.375 per share and consultants and service providers options and warrants to purchase 260,000 shares of common shares, with a weighted average exercise price of \$1.81 exercisable at prices ranging from \$0.55 to \$3.00 were outstanding. In January 2005, the Company entered into a convertible note agreement with Telkooor, according to which Telkooor loaned a \$250,000 interest free convertible note to be paid on the tenth business day after the Company announced its financial results for 2005. The note may be converted into Common stock at a rate of \$ 1.06 per share. Automatic conversion shall occur if the Company meets its set budget for 2005. The exercise of these options and warrants may have an adverse effect on the price of our common share and will dilute existing shareholder percentage ownership in the Company.

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### Substantial Ownership by Telkooor

As of December 31, 2004, Telkooor owns approximately 43% of the outstanding shares of Common Stock of the Company. In January 2005, the Company entered into a convertible note agreement with Telkooor, according to which Telkooor loaned a \$250,000 interest free convertible note to be paid on the tenth business day after the Company announced its financial results for 2005. The note may be converted into Common stock at a rate of \$1.06 per share. Automatic conversion shall occur if the Company meets its set budget for 2005. Telkooor ownership makes it difficult for other shareholders to propose changes or change the Board of Directors. Currently, certain shareholders and managers of Telkooor are in a dispute. This dispute may divert limited resources and disrupt our business. See "management" section above.

We are dependent on Telkooor's new design and transfer of production to third party manufacturers

We are dependent on Telkooor's intellectual property and its ability to provide prototypes, pilot production and transfer production to third party manufacturers in the Far East for cost reductions. Due to concern over engineering resource limitations and prioritization of those resources, we cannot be assured that Telkooor will be able to meet our customer's needs. We also depend on Telkooor's ability to transfer manufacturing satisfactory and timely to third party manufacturer. Failure to obtain new products or delay in transferring to third party low cost subcontract manufacturers will have an adverse effect on our ability to successfully provide our products and be competitive or profitable in our market place.

Legislative actions, higher insurance cost and potential new accounting pronouncements are likely to cause our general and administrative expenses to increase and impact our future financial position and results of operations.

We are working diligently toward evaluating and documenting our internal control systems in order to allow management to report on, and our independent auditors to attest to, our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002. Compliance may require us to retain additional personnel and/or additional outside legal, accounting and advisory services, which will increase general and administrative expenses. There can be no assurances that the evaluation required by Sarbanes-Oxley Section 404 will not result in the identification of significant control deficiencies or that our auditors will be able to attest to the effectiveness of our internal control over financial reporting.

Proposed changes in the accounting rules, including legislative and other proposals to account for employee stock options as a compensation expense among others, could materially increase the expenses that we report under generally accepted accounting principles and adversely affect our operating results.

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## Intellectual Property

While Digital owns the intellectual property rights on its legacy products (the US, UP and UPF Series), Telkooor designed and developed the newer products (the CPCI, Strongbox and eF Series) at its expense and owns the intellectual property rights. Further, all of these new products sold by Digital to date were manufactured by Telkooor in Israel and shipped to Digital Power at a transfer price which allowed for some gross margins to be earned by Telkooor. This exposes Digital Power to potentially lower gross margins on these products. Digital and Telkooor plan to enter into an agreement to manufacture these products in a lower cost environment to allow for improved gross margins. However, no assurances can be given that such an agreement will be formalized, which could result in continued lower margins.

## ITEM 7. FINANCIAL STATEMENTS.

The financial statements of the Company, including the notes thereto and report of the independent auditors thereon, are attached hereto as exhibits as page numbers F-1 through F-26.

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## DIGITAL POWER CORPORATION

## CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004

IN U.S. DOLLARS

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[GRAPHIC OMITTED]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

DIGITAL POWER CORPORATION

We have audited the accompanying consolidated balance sheet of Digital Power Corporation ("the Company") and its subsidiary as of December 31, 2004, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We are not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiary as of December 31, 2004, and the consolidated results of their operations and cash flows for the two years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel  
February 10, 2005

/s/ KOST FORER GABBAY & KASIERER  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

DIGITAL POWER CORPORATION  
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CONSOLIDATED BALANCE SHEET  
-----

U.S. dollars in thousands (except share data)

ASSETS

CURRENT ASSETS:

Cash and cash equivalents  
Restricted cash  
Trade receivables, net of allowance for doubtful accounts of \$118  
Prepaid expenses and other receivables  
Inventories (Note 3)

Total current assets  
-----

LONG-TERM LEASE DEPOSITS

PROPERTY AND EQUIPMENT, NET (Note 4)

Total assets  
-----

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:

Accounts payable  
Related parties - trade payables account (Note 10)  
Other current liabilities (Note 6)

Total current liabilities  
-----

COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)

SHAREHOLDERS' EQUITY (Note 8):

Series A redeemable, convertible Preferred shares, no par value: 500,000 shares  
authorized, 0 shares issued and outstanding as of December 31, 2004  
Preferred shares, no par value: 1,500,000 shares authorized, 0 shares issued

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and outstanding as of December 31, 2004  
Common shares, no par value: 10,000,000 shares authorized; 6,161,859 shares  
issued and outstanding as of December 31, 2004  
Additional paid-in capital  
Deferred stock compensation  
Accumulated deficit  
Accumulated other comprehensive income

Total shareholders' equity  
-----

Total liabilities and shareholders' equity  
-----

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

-----  
U.S. dollars in thousands (except share and per share data)

Revenues (Note 11)  
Cost of revenues (Note 10)  
Write-off of excess inventory

Gross profit

Operating expenses:  
Engineering and product development  
Selling and marketing  
General and administrative

Total operating expenses  
-----

Operating loss

Financial income, net  
-----

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Loss before tax benefit  
 Tax benefit (Note 9)

Net loss

Basic and diluted net loss per share

Weighted average number of shares used in computing basic and diluted  
 net loss per share

-----  
 \$  
 =====  
 \$  
 =====  
 5  
 =====

The accompanying notes are an integral part of the consolidated financial statements.

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DIGITAL POWER CORPORATION

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands (except share data)

	Common shares		Add'l	Deferred	Accumulated	Ot
	Number	Amount	paid-in	stock	deficit	accum
	-----	-----	capital	compensation	-----	pre
						income
	-----	-----	-----	-----	-----	-----
Balance as of January 1, 2003	4,510,680	\$11,036	\$ 837	\$ -	\$ (8,482)	\$
Issuance of Common shares, net	900,000	-	600	-	-	
Comprehensive loss:						
Net loss	-	-	-	-	(963)	
Foreign currency translation	-	-	-	-	-	
adjustments						
Total comprehensive loss	-	-	-	-	-	
Balance as of December 31, 2003	5,410,680	11,036	1,437	-	(9,445)	
Issuance of Common shares, net	716,179	-	743	-	-	
Deferred stock compensation						
related to options granted						
to an employee	-	-	25	(25)	-	
Amortization of deferred stock						
compensation related to options						
granted to an employee	-	-	-	12	-	
Exercise of options granted to						



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employees	35,000	-	22	-	-	
Comprehensive loss:						
Net loss	-	-	-	-	(1,175)	
Foreign currency translation adjustments	-	-	-	-	-	
Total comprehensive loss						
Balance as of December 31, 2004	6,161,859	\$11,036	\$ 2,227	\$ (13)	\$ (10,620)	\$

The accompanying notes are an integral part of the consolidated financial statements.

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DIGITAL POWER CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

Cash flows from operating activities:

Net loss \$  
 Adjustments required to reconcile net loss to net cash used in operating activities:  
 Depreciation  
 Amortization of deferred stock compensation related to options granted to an employee  
 Decrease in deferred income taxes, net  
 Decrease (increase) in trade receivables  
 Decrease (increase) in prepaid expenses and other receivables  
 Decrease (increase) in inventories  
 Increase (decrease) in accounts payables  
 Increase (decrease) in other current liabilities  
 Other

Net cash used in operating activities

Cash flows from investing activities:

Restricted cash  
 Purchase of property and equipment  
 Repayment of long-term loan

Net cash provided by investing activities

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### Cash flows from financing activities:

Payments made on short-term bank credit  
Principal payments of capital lease obligations  
Proceeds from issuance of Common shares, net  
Exercise of options granted to employees

Net cash provided by financing activities

Effect of exchange rate changes on cash and cash equivalents

Increase in cash and cash equivalents

Cash and cash equivalents at the beginning of the year

Cash and cash equivalents at the end of the year

### Supplemental disclosure of cash flows activities:

Interest paid

The accompanying notes are an integral part of the consolidated financial statements.

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### DIGITAL POWER CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

#### NOTE 1:- GENERAL

- a. Digital Power Corporation ("the Company" or "DPC") was incorporated in 1969, under the General Corporation Law of the State of California. The Company has a wholly-owned subsidiary, Digital Power Limited ("DPL"), located in the United Kingdom. The Company and its subsidiary are currently engaged in the design, manufacture and sale of switching power supplies and converters. The Company has two reportable geographic segments - North America (sales through DPC) and Europe (sales through DPL).
- b. The Company depends on Telkooor Telecom Ltd. ("Telkooor"), a major shareholder in the Company, and another major subcontractor for producing its products. If these manufacturers were to be unable or unwilling to continue manufacturing the Company's products in required volumes on a timely basis, any resulting manufacturing delays could result in the loss of sales, which could adversely affect operating results and cash position. The Company also depends on Telkooor's intellectual property and ability to transfer production to third party manufacturers. Failure to obtain new products or delay in transferring to third party low cost subcontract manufacturers will have an adverse

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effect on the ability of the Company to successfully provide products.

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP").

a. Use of estimates:

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

The financial statements of the foreign subsidiary, whose functional currency has been determined to be its local currency, have been translated into U.S. dollars in accordance with Statement of Financial Accounting Standard No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive income (loss) in shareholders' equity.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. Intercompany transactions and balances have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less.

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### DIGITAL POWER CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. dollars in thousands

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Restricted cash:

Restricted cash is invested in a deposit, which matures within less than three months and is used to secure a letter of credit issued by the Company's bank.

f. Inventories:

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Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items or technological obsolescence.

Cost is determined as follows:

Raw materials, parts and supplies - using the "first-in, first-out" method.

Work-in-progress and finished products - on the basis of direct manufacturing costs with the addition of indirect manufacturing costs.

The Company periodically assesses its inventories valuation in accordance with dead and slow moving items, revenue forecasts and technological obsolescence. When inventories on hand exceed the foreseeable demand or become obsolete, the value of excess inventory, which at the time of the review was not expected to be sold, is written off.

During 2004 and 2003, the Company recorded inventories write-offs in a total amount of \$ 218 and \$ 46, respectively.

g. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives, at the following annual rates:

	%
	-----
Computers, software and related equipment	20 - 33
Office furniture and equipment	10 - 20
Motor vehicles	20 - 33
Leasehold improvements	Over the term of the lease

The long-lived assets of the Company and its subsidiary are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets.

During 2003 and 2004, no impairment losses have been identified.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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h. Revenue recognition:

The Company and its subsidiary generate their revenues from the sale of their products. The Company and its subsidiary sell their products through direct and indirect sales force. The sales through an indirect sales force is also considered as sales to end users.

Revenues from products are recognized in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB No. 104"), when the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the seller's price to the buyer is fixed or determinable, no further obligation exists and collectibility is reasonably assured.

Generally, the Company does not grant a right of return. Revenues subject to certain stock rotation are deferred until the products are sold to the end customer or until the rotation rights expire. Certain distributors are allowed, in the sixth month after the initial stock purchase, to rotate stock that has not been sold for other products. This may be repeated each sixth month thereafter for 18 months, at no more than 25% of the distributor's purchase during the previous six months.

Service revenues are deferred and recognized on a straight-line basis over the term of the service agreement.

i. Engineering and product development:

Engineering and product development costs are charged to the statement of operations as incurred.

j. Income taxes:

The Company and its subsidiary account for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiary provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Warranty costs:

The Company offers a 12 month warranty period for all of its products. The Company estimates the costs that may be

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incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of units, historical rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company's warranty allowance during the period are as follows:

	Year ended December 31, 2004
	-----
Balance at the beginning of the year	\$ 111
Warranties issued during the year	131
Settlements made during the year	(85)
Changes in liability for pre-existing warranties during the year, including expirations	(41)
	-----
Balance at the end of the year	\$ 116
	=====

1. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Statement No. 25, "Accounting for Stock Options Issued to Employees" ("APB No. 25") and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of an employee stock option is equivalent to or above the market price of the underlying stock on the date of grant, no compensation expense is recognized.

The Company adopted the disclosure provisions of Financial Accounting Standards Board Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS No. 148"), which amended certain provisions of SFAS 123 to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation, effective as of the beginning of the prior fiscal year. The Company continues to apply the provisions of APB No. 25, in accounting for stock-based compensation.

Pro forma information regarding the Company's net loss and net loss per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

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U.S. dollars in thousands

NOTE 2:-           SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The fair value for options granted in 2004 and 2003 is amortized over their vesting period and estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

	2004
Dividend yield	0%
Expected volatility	107% -
Risk-free interest	3% - 3
Expected life of up to	5-7 ye

Pro forma information under SFAS No. 123 is as follows:

Net loss available to Ordinary shares - as reported	\$
Deduct - stock-based employee compensation - intrinsic value	
Add - stock-based employee compensation - fair value	
Pro forma:	
Net loss	\$
Net loss per share:	
Basic and diluted net loss, as reported	\$
Pro forma basic and diluted net loss	\$

m. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, restricted cash, trade receivables, accounts payable and other current liabilities approximate their fair value due to the short-term maturity of such instruments.

n. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of Common shares outstanding during each year. Diluted net earnings per share is computed based on the weighted average number of Common shares outstanding during each year, plus dilutive potential Common shares considered outstanding during the year, in accordance with Statement of Financial Accounting Standard No. 128, "Earnings per Share" ("SFAS No. 128").

The total number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share because these securities are anti-dilutive was 1,550,425, and 1,232,460 for the years ended December 31, 2004 and 2003, respectively.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

o. Concentrations of credit risks:

Financial instruments that potentially subject the Company and its subsidiary to concentrations of credit risk consist principally of cash and cash equivalents, restricted cash and trade receivables.

Cash and cash equivalents and restricted cash are invested in banks in the U.S. and in the U.K. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's and its subsidiary's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

Trade receivables of the Company and its subsidiary are mainly derived from sales to customers located primarily in the U.S and in Europe. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiary have determined to be doubtful of collection.

The Company and its subsidiary have no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

p. Impact of recently issued accounting standards:

In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4." ("SAFS No. 151"). SFAS No. 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SAFS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS No. 151 will have a



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material effect on its financial position or results of operations.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 123 (revised 2004) ("SFAS No. 123(R)"), "Share-Based Payment", which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes APB No. 25, and amends FASB Statement No. 95, "Statement of Cash Flows". Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

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### DIGITAL POWER CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

SFAS No. 123(R) must be adopted no later than the beginning of the first annual period beginning after December 15, 2005. The Company expects to adopt SFAS No. 123(R) on January 1, 2006.

SFAS No. 123 (R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS No. 123(R) using the modified-prospective method.

As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB No. 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123 (R)'s fair value method will have a significant impact on the result of operations, although it will have no impact on the overall financial position. The impact of adoption of SFAS No. 123(R) cannot

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be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123(R) in prior periods, the impact of that Standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net loss and loss per share above in note 2 to our consolidated financial statements.

NOTE 3:- INVENTORIES

	December 31, 2004
Raw materials, parts and supplies	\$ 360
Work in progress	388
Finished products	734
	\$ 1,482

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 4:- PROPERTY AND EQUIPMENT

	December 31, 2004
Cost:	
Computers, software and related equipment	\$ 675
Office furniture and equipment	509
Motor vehicles	74
Leasehold improvements	417
	1,675
Accumulated depreciation	
Computers, software and related equipment	620
Office furniture and equipment	488
Motor vehicles	74
Leasehold improvements	243
	1,425
Depreciated cost	\$ 250

NOTE 5:- SHORT-TERM BANK CREDIT

Since May 2003, the Company has a line of credit from

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Silicon Valley Bank ("SVB"). The Company can borrow up to \$ 1,200 at SVB's prime rate plus 1.75% (totaling 5.25% at December 31, 2004). In order to use the line of credit, the Company is required to maintain certain ratios and be in compliance with other covenants. Interest only is payable on a monthly basis. The maturity date of the line of credit is August 30, 2005. As of December 31, 2004, the Company had not yet utilized its line of credit.

If the Company exercises its line of credit, the Company must in return grant the bank a continuing security interest in all presently existing and later acquired collateral to secure all obligations and performance of its duties towards the bank.

NOTE 6:- OTHER CURRENT LIABILITIES

	December 31, 2004
	-----
Accrued payroll and payroll taxes	\$ 91
Warranty costs	116
Advances from customers	33
Deferred revenues	242
Government authorities	39
Accrued expenses	166
Other	14
	-----
	\$ 701

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DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands (except share and per share data)

NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Company and its subsidiary rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2009. Future rental commitments under non-cancelable leases are as follows:

Year ended December 31,		
-----		
2005	\$	304
2006		298
2007		303
2008		189
2009		189
		-----

\$ 1,283

=====

Total rent expenses for the years ended December 31, 2004 and 2003, were approximately \$298 and \$244, respectively.

b. Litigation:

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. ("Tek-Tron"). Tek-Tron was seeking damages of approximately \$ 300 for breach of contract and conversion of parts and infrastructure owned by Tek-Tron located in the Company's former subsidiary, Poder Digital S.A.'s Mexico manufacturing plant. In April 2004, the Company signed a settlement agreement with Tek-Tron, according to which the Company agreed to pay \$90 in installments and return certain disputed inventory for a full release. As of December 31, 2004, the Company paid the \$90 in full. The settlement agreement allows Tek-Tron to seek arbitration limited to the sum of \$50, in case the parties do not agree on a resolution regarding the returned inventory. Tek-Tron has notified the Company that it believes that the disputed inventory contains missing labeling and inspection reports. The Company continues to work toward reaching a resolution over the returned property for which the Company has a maximum liability of \$50 under the settlement agreement. The Company's management and its litigation counsel are unable to assess the outcome of such arbitration proceeding.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 8:- SHAREHOLDERS' EQUITY

a. Preferred shares:

There is one authorized series of Preferred shares in the amount of 500,000 shares of Series A cumulative redeemable convertible Preferred shares ("Series A"), and an additional 1,500,000 Preferred shares have been authorized, but the rights, preferences, privileges and restrictions on these shares have not been determined. DPC's Board of Directors is authorized to create a new series of Preferred shares and fix the number of shares as well as the rights, preferences, privileges and restrictions granted to or imposed upon any series of Preferred shares. As of December 31, 2004, there were no shares issued or outstanding.

b. Common shares:

Common shares confer upon the holders the rights to receive notice to participate and vote in the general meeting of shareholders of the Company, to receive dividends, if and when declared, and to participate in a distribution of surplus of assets upon liquidation of the Company.

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On March 31, 2003, the Company entered into an agreement to sell 900,000 Common shares to Telkoor, in consideration for \$600, net of issuance expenses.

During 2004, the Company issued 511,261 Common shares to Telkoor in consideration of \$493, net of issuance expenses at the average closing price of the Company's Common shares during the twenty trading days preceding the closing date.

In June 2004, the Company issued 204,918 Common shares to a new investor, in consideration of \$250, at the price of the average closing price of the Company's Common shares during the twenty trading days preceding the closing date..

c. Share Option Plans:

1. Under the Company's stock option plans ("the plan"), options may be granted to employees, officers, consultants, service providers and directors of the Company or its subsidiary.
2. As of December 31, 2004, the Company has authorized, by several Incentive Share Option Plans, the grant of options to officers, management, other key employees and other of up to 2,272,500 of the Company's Common shares. As of December 31, 2004, an aggregate of 522,480 of the Company's options are still available for future grant.
3. The options granted generally become fully exercisable after four years and expire no later than 10 years from the approval date of the option plan under terms of grant. Any options that are forfeited or cancelled before expiration become available for future grants.

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DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 8:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the Company's employees share option activity, (except options to consultants and service providers) and related information is as follows:

	Year ended Decem	
	2004	
Amount of options		Weighted average exercise price

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Outstanding at the beginning of the year	972,460	\$ 1.19
Granted	379,000	\$ 1.03
Exercised	(35,000)	\$ 0.59
Forfeited	(26,035)	\$ 0.62
Outstanding at the end of the year	1,290,425	\$ 1.28
Exercisable options at the end of the year	925,175	\$ 1.39

In connection with the grant of certain share options to an employee in 2004, the Company recorded amortization of deferred share compensation of \$25, for the aggregate differences between the respective exercise price of options at their date of grant and the fair value of the Common shares subject to such options. Unamortized deferred stock compensation is presented as a reduction in shareholders' equity and is amortized ratably over the vesting period of the related options.

The options outstanding as of December 31, 2004, have been classified by exercise price, as follows:

Exercise price	Options outstanding of as December 31, 2004	Weighted average contractual life Years	Weighted average exercise price	Options outstanding at December 31, 2004
\$0.48-0.60	40,000	8.11	\$ 0.57	
\$0.70-1.05	804,000	8.07	\$ 0.86	
\$1.30-1.813	143,535	5.44	\$ 1.63	
\$2.31-2.375	302,890	3.17	\$ 2.32	
	1,290,425	6.63	\$ 1.28	

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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NOTE 8:- SHAREHOLDERS' EQUITY (Cont.)

d. Warrants and options issued to service providers and consultants:

1. The Company's outstanding options to consultants and service providers as of December 31, 2004, are as follows:

Issuance date	Options for Common shares	Exercise price per share	Option exercis
-----	-----	-----	-----
January 2002	100,000	\$ 3	100
May 2002	40,000	\$ 1	40
August 2002	10,000	\$ 1	10
November 2002	10,000	\$ 1	10
January 2004	100,000	\$ 1.16	100
	-----		-----
	260,000		260,
	=====		=====

\*) 10 years from the date of grant.

During 2004, none of the options were exercised.

2. On January 16, 2004, the Board of Directors cancelled the options to purchase 100,000 Common shares at \$3 per share that were granted on January 1, 2002, and 100,000 Common shares at \$3 per share that were granted on January 1, 2004, which the Company was obligated to grant under the Termination and Consulting Agreement with a former CEO. In lieu thereof, the former CEO was granted options to purchase 100,000 shares at \$1.16 per share.

The Company evaluated the modification according to SFAS No. 123. Since the fair value of the modified options were lower than the fair value of the original options at the date of modification, no compensation expenses were recorded.

e. Employee Stock Ownership Plan:

The Company has an Employee Stock Ownership Plan ("ESOP") covering eligible employees. The ESOP provides for the Employee Stock Ownership Trust ("ESOT") to distribute shares of the Company's Common shares as retirement benefits to the participants. The Company did not distribute shares ever since 1998. As of December 31, 2004, the outstanding Common shares held by the ESOT are 167,504.

f. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in U.S. dollars. The Company

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does not intend to pay cash dividends in the foreseeable future.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 9:- TAXES ON INCOME

- a. Taxes on income are comprised of \$ 25 and \$ 77 of foreign current taxes for the years ended December 31, 2004 and 2003, respectively.
- b. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets are as follows:

Operating loss carryforward  
Reserves and allowances

Net deferred tax asset before valuation allowance  
Valuation allowance

Net deferred tax asset

As of December 31, 2004, the Company and its subsidiary provided a valuation allowance of \$2,910 on respect of deferred tax assets resulting from short-term temporary differences and depreciation charged in advance of a capital allowance taken and from carryforward losses. During the fiscal year 2004, the Company increased the tax valuation by \$ 1,145.

Management currently believes that since the Company and its subsidiary have a history of losses, it is more likely than not that the deferred tax assets regarding the remainder of the loss carryforwards and other temporary differences will not be realized in the foreseeable future.



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c. Net operating losses carryforwards:

As of December 31, 2004, the Company had approximately \$4,780 in federal net operating loss carryforwards for income tax purposes, which can be carried forward and offset against taxable income for 20 years and expire in 2022 - 2024.

Utilization of U.S. net operating losses may be subject to substantial annual limitation, due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

d. The main reconciling items between the statutory tax rate of the Company and the effective tax rate are the non-recognition of tax benefits resulted from the Company's accumulated net operating losses carryforward due to the uncertainty of the realization of such tax benefits.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- TAXES ON INCOME (Cont.)

e. Net loss before tax benefit consists of the following:

Domestic (U.S.)  
Foreign (U.K.)

Year  
-----  
20  
-----  
\$  
-----  
\$ ( )  
=====

NOTE 10:- RELATED PARTY TRANSACTIONS

The results of operations from transactions with Telkoor, a major shareholder, were as follows:

Year  
-----  
2004

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Purchases of products from Telkoor

\$ 1,94

Transactions with Telkoor derive mainly from purchase of power supplies from Telkoor.

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENTS CUSTOMERS AND GEOGRAPHICAL INFORMATION

- a. The Company has two reportable geographic segments, see Note 1a for a brief description of the Company's business. The data is presented in accordance with Statement of Financial Accounting Standard No.131, "Disclosure About Segments of an Enterprise and Related Information ("SFAS No. 131").

The following data presents the revenues expenditures and other operating data of the Company's geographic operating segments:

	Year ended December 31,		
	DPC	DPL	Elimi
Revenues	\$ 3,854	\$ 4,859	\$
Intersegment revenues	749	-	
Total revenues	\$ 4,603	\$ 4,859	\$
Depreciation expense	\$ 30	\$ 74	\$
Operating loss	\$ 655	\$ 590	\$
Financial income, net			
Loss before tax benefit			
Tax benefit	\$ -	\$ 25	\$

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Net loss	\$ 643	\$ 532	\$
Expenditures for segment assets as of December 31, 2004	\$ 16	\$ 11	\$
Identifiable assets as of December 31, 2004	\$ 1,835	\$ 3,328	\$

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENTS CUSTOMERS AND GEOGRAPHICAL INFORMATION (Cont.)

	Year ended December 31,		
	DPC	DPL	Elimi
Revenues	\$ 3,417	\$ 3,952	\$
Intersegment revenues	677	-	
Total revenues	\$ 4,094	\$ 3,952	\$
Depreciation expense	\$ 37	\$ 94	\$
Operating loss	\$ (782)	\$ (283)	\$
Financial income, net			
Loss before tax benefit			
Tax benefit	\$ -	\$ 77	\$
Net loss	\$ (799)	\$ (164)	\$
Expenditures for segment assets as of December 31, 2003	\$ 15	\$ 52	\$
Identifiable assets as of December 31, 2003	\$ 2,054	\$ 3,082	\$

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b. Major customers' data as percentage of total sales:

Customer A

Customer B

c. Total revenues from external customers divided on the basis of the Company's product lines are as follows:

Revenues:  
Commercial products  
Defense products

Y  
-----  
2  
-----  
=====  
  
Y  
-----  
2  
-----  
\$  
-----  
\$  
=====

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DIGITAL POWER CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- SUBSEQUENT EVENTS

In January 2005, the Company entered into a convertible note agreement with Telkooor, according to which Telkooor loaned a \$250 interest free convertible note to be paid on the tenth business day after the Company announced its financial results for 2005. The note may be converted into Common stock at a rate of \$1.06 per share. Automatic conversion shall occur if the Company meets its set budget for 2005.

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ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 8A. CONTROLS AND PROCEDURES.

We carried out an evaluation, under the supervision and with the participation of the our management, including our Chief Executive Officer and Chief Financial Officer, about the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this Form 10-KSB are effective in timely alerting them to material information required to be included in this Form 10-KSB.

ITEM 8B. OTHER INFORMATION.

None.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

The information called for in Item 9 of Part III is incorporated by reference from the definitive proxy statement of the Company to be filed with the Securities and Exchange Commission within 180 days from fiscal year end.

ITEM 10. EXECUTIVE COMPENSATION.

The information called for in Item 10 of Part III is incorporated by reference from the definitive proxy statement of the Company to be filed with the Securities and Exchange Commission within 180 days from fiscal year end.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information called for in Item 11 of Part III is incorporated by reference from the definitive proxy statement of the Company to be filed with the Securities and Exchange Commission within 180 days from fiscal year end.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The information called for in Item 12 of Part III is incorporated by reference from the definitive proxy statement of the Company to be filed with the Securities and Exchange Commission within 180 days from fiscal year end.

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ITEM 13. EXHIBITS

(a) Exhibits

3.1 Amended and Restated Articles of Incorporation of Digital Power

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- Corporation(1)
- 3.2 Amendment to Articles of Incorporation(1)
- 3.3 Bylaws of Digital Power Corporation(1)
- 4.1 Specimen Common Stock Certificate(2)
- 4.2 Specimen Warrant(1)
- 4.3 Representative's Warrant(1)
- 10.1 Revolving Credit Facility with San Jose National Bank(1)
- 10.2 KDK Contract(1)
- 10.3 Agreement with Fortron/Source Corp.(1)
- 10.4 Employment Agreement With Robert O. Smith(2)
- 10.5 1996 Stock Option Plan(1)
- 10.6 Gresham Power Asset Purchase Agreement(3)
- 10.7 1998 Stock Option Plan
- 10.8 Technology Transfer Agreement with KDK Electronics(4)
- 10.9 Loan Commitment and Letter Agreement(5)
- 10.10 Promissory Note(5)
- 10.11 Employment Agreement with Robert O. Smith (6)
- 10.12 Securities Purchase Agreement between the Company and Telkooor Telecom, Ltd. (now Telkooor Power Ltd.) (7)
- 10.11 Securities Purchase Agreement between the Company and Telkooor Telecom, Ltd. (now Telkooor Power Ltd.) (8)
- 10.12 Employment Letter with David Amitai (9)
- 10.13 Employment Agreement with Jonathan Wax (9)
- 10.14 Convertible Note with Telkooor Power Ltd. (10)
- 21.1 The Company's sole subsidiary is Digital Power Limited, a corporation formed under the laws of the United Kingdom.
- 23.1 Consent of Ernst & Young
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act
  
- (1) Previously filed with the Commission on October 16, 1996, to the Company's Registration Statement on Form SB-2.
- (2) Previously filed with the Commission on December 3, 1996, to the Company's Pre-Effective Amendment No. 1 to Registration Statement on Form SB-2.
- (3) Previously filed with the Commission on February 2, 1998, to the Company's Form 8-K.
- (4) Previously filed with the Commission with its Form 10-QSB for the quarter ended September 30, 1998.
- (5) Previously filed with the Commission with its Form 10-KSB for the year ended December 31, 1998.
- (6) Previously filed with the Commission with its Form 10-KSB for the year ended December 31, 1999.
- (7) Previously filed with the Commission with its Form 8-K filed on November 21, 2001.
- (8) Previously filed with the Commission with its Form 8-K filed on January 14, 2004.
- (9) Previously filed with the Commission with its Form 10-KSB for the year ended December 31, 2003.
- (10) Previously filed with the Commission with its Form 8-K filed on February 9, 2005.

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### Item 14. Principal Accounting Fees and Services.

The information called for in Item 14 of Part III is incorporated by

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reference from the definitive proxy statement of the Company to be filed with the Securities and Exchange Commission within 180 days from fiscal year end.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DIGITAL POWER CORPORATION,  
a California Corporation

Dated: March 28, 2005

/s/ Jonathan Wax

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Jonathan Wax,  
President and Chief Executive Officer  
(Principal Executive Officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Dated: March 29, 2005

/s/ Ben Zion Diamant

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Ben Zion Diamant, Chairman

Dated: March 28, 2005

/s/ Jonathan Wax

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Jonathan Wax, President and  
Chief Executive Officer  
(Principal Executive Officer)

Dated: March 27, 2005

/s/ David Amitai

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David Amitai, Director

Dated: March 28, 2005

/s/ Amos Kohn

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Amos Kohn, Director

Dated: March 28, 2005

/s/ Yeheskel Manea

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Yeheskel Manea, Director

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Dated: March 27, 2005

/s/ Youval Menipaz

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Youval Menipaz, Director

Dated: March 28, 2005

/s/ Leo Yen

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Leo Yen, Chief Financial Officer  
(Principal Accounting and Financial  
Officer)