

DIGITAL POWER CORP  
Form 10QSB  
August 15, 2007

U.S. Securities and Exchange Commission  
Washington, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended June 30, 2007

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 1-12711

DIGITAL POWER CORPORATION  
(Exact name of small business issuer as specified in its charter)

California  
(State or other jurisdiction of  
Incorporation or organization)

94-1721931  
(IRS Employer Identification No.)

41920 Christy Street, Fremont, CA 94538-3158  
(Address of principal executive offices)

(510) 657-2635  
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the 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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 6,610,708 shares of Common Stock, no par value, were outstanding as of August 10, 2007.

Transitional Small Business Disclosure Format (check one)

Yes  No

**DIGITAL POWER CORPORATION**  
**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**  
**AS OF JUNE 30, 2007**  
**IN U.S. DOLLARS**  
**UNAUDITED**

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The Board of Directors  
Digital Power Corporation

Re: Review of unaudited interim consolidated financial statements  
for the six-month period ended June 30, 2007

We have reviewed the accompanying consolidated balance sheet of Digital Power Corporation ("the Company") and its subsidiaries as of June 30, 2007, and the related consolidated statements of operations for the three-month and six-month periods ended June 30, 2007 and 2006, and the statement of changes in shareholders' equity for the six-month period ended June 30, 2007 and the statements of cash flows for the six-month period ended June 30, 2007 and 2006. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated interim financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel  
August 14 , 2007

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

## DIGITAL POWER CORPORATION

**CONSOLIDATED BALANCE SHEET**

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

**June 30,  
2007  
Unaudited**

**ASSETS****CURRENT ASSETS:**

|   |           |              |
|---|-----------|--------------|
| Cash and cash equivalents   | \$        | 1,427        |
| Restricted cash   |           | 106          |
| Trade receivables, net of allowance for doubtful accounts of \$ 124 |           | 1,738        |
| Prepaid expenses and other receivables                              |           | 153          |
| Inventories   |           | 1,621        |
| <b>Total</b> current assets   | <b>\$</b> | <b>5,045</b> |

**PROPERTY AND EQUIPMENT, NET**

152

|                     |           |              |
|---------------------|-----------|--------------|
| <b>Total</b> assets | <b>\$</b> | <b>5,197</b> |
|---------------------|-----------|--------------|

**LIABILITIES AND SHAREHOLDERS' EQUITY****CURRENT LIABILITIES:**

|                                  |    |              |
|----------------------------------|----|--------------|
| Accounts payable                 | \$ | 534          |
| Related parties - trade payables |    | 779          |
| Deferred revenues                |    | 10           |
| Other current liabilities        |    | 468          |
| <b>Total</b> current liabilities |    | <b>1,791</b> |

**SHAREHOLDERS' EQUITY:**

## Share capital -

Series A redeemable, convertible Preferred shares, no par value - 500,000 shares authorized, 0 shares issued and outstanding at June 30, 2007

Preferred shares, no par value - 1,500,000 shares authorized, 0 shares issued and outstanding at June 30, 2007

Common shares, no par value - 30,000,000 shares authorized; 6,610,708 shares issued and outstanding at June 30, 2007

11,036

Additional paid-in capital

2,782

Accumulated deficit

(10,624)

Accumulated other comprehensive income

212

|                                   |           |              |
|-----------------------------------|-----------|--------------|
| <b>Total</b> shareholders' equity | <b>\$</b> | <b>3,406</b> |
|-----------------------------------|-----------|--------------|

|   |    |       |
|---|----|-------|
| <u>Total</u> liabilities and shareholders' equity | \$ | 5,197 |
|---|----|-------|

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

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## DIGITAL POWER CORPORATION

**CONSOLIDATED STATEMENTS OF OPERATIONS**

U.S. dollars in thousands, except share and per share data

|                                       | Six months ended<br>June 30, |           | Three months ended<br>June 30, |          |
|---------------------------------------|------------------------------|-----------|--------------------------------|----------|
|                                       | 2007                         | 2006      | 2007                           | 2006     |
|                                       |                              | Unaudited |                                |          |
| Revenues                              | \$ 5,278                     | \$ 6,041  | \$ 2,536                       | \$ 3,333 |
| Cost of revenues                      | 3,939                        | 4,398     | 1,972                          | 2,472    |
| Gross profit                          | 1,339                        | 1,643     | 564                            | 861      |
| Operating expenses:                   |                              |           |                                |          |
| Engineering and product development   | 402                          | 310       | 181                            | 172      |
| Selling and marketing                 | 478                          | 617       | 249                            | 315      |
| General and administrative            | 634                          | 650       | 334                            | 346      |
| <u>Total operating expenses</u>       | 1,514                        | 1,577     | 764                            | 833      |
| Operating income (loss)               | (175)                        | 66        | (200)                          | 28       |
| Financial income (expenses), net      | 29                           | (12)      | 13                             | (11)     |
| Income (loss) before income taxes     | (146)                        | 54        | (187)                          | 17       |
| Income taxes                          | (9)                          | -         | (9)                            | -        |
| Net income (loss)                     | \$ (155)                     | \$ 54     | \$ (196)                       | \$ 17    |
| Basic net earnings (loss) per share   | \$ (0.023)                   | \$ 0.009  | \$ (0.030)                     | \$ 0.003 |
| Diluted net earnings (loss) per share | \$ (0.023)                   | \$ 0.008  | \$ (0.030)                     | \$ 0.002 |

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

## DIGITAL POWER CORPORATION

**STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**

U.S. dollars in thousands, except share data

|   | Common shares<br>Number | Amount | Additional<br>paid-in<br>capital | Accumulated<br>deficit | Accumulated<br>other<br>comprehensive<br>income | Total<br>other<br>comprehensive<br>loss | Total<br>shareholders'<br>equity |
|---|-------------------------|--------|----------------------------------|------------------------|---|---|----------------------------------|
| Balance as of January 1, 2007   | 6,610,708               | \$ -   | \$ 13,768                        | \$ (10,463)            | \$ 166  | -                                       | \$ 3,471                         |
| Stock compensation related to options granted to Telkoor's employees        | -                       | -      | 24                               | -                      | -   | -                                       | 24                               |
| Stock compensation related to options granted to employees                  | -                       | -      | 26                               | -                      | -   | -                                       | 26                               |
| Comprehensive income:   |                         |        |                                  |                        |   |   |                                  |
| Net income (loss)   | -                       | -      | -                                | (155)                  | -   | (155)                                   | (155)                            |
| Foreign currency translation adjustments                                    | -                       | -      | -                                | -                      | 46  | 46                                      | 46                               |
| Cumulative impact of change in accounting for uncertainties in income taxes |                         |        |                                  | (6)                    |   |   | (6)                              |
| Total other comprehensive income  |                         |        |                                  |                        | \$  | (109)                                   |                                  |
| Balance as of June 30, 2007 (unaudited)                                     | 6,610,708               | \$ -   | \$ 13,818                        | \$ (10,624)            | \$ 212  |   | \$ 3,406                         |

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

## DIGITAL POWER CORPORATION

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

|   | Six months ended<br>June 30, |          |
|---|------------------------------|----------|
|   | 2007                         | 2006     |
|   | Unaudited                    |          |
| <b><u>Cash flows from operating activities:</u></b>   |                              |          |
| Net (loss) income   | \$ (155)                     | \$ 54    |
| Adjustments required to reconcile net (loss) income to net cash provided by (used in) operating activities: |                              |          |
| Depreciation  | 34                           | 39       |
| Stock compensation related to options granted to employees  | 26                           | 12       |
| Stock compensation related to options granted to Telkoo's employees   | 24                           | 27       |
| Decrease (increase) in trade receivables, net   | 481                          | (246)    |
| Decrease (increase) in prepaid expenses and other receivables   | (12)                         | 2        |
| Increase in inventories   | (10)                         | (347)    |
| Increase (decrease) in accounts payable and related parties- trade payables                                 | (400)                        | 580      |
| Decrease in deferred revenues and other current liabilities   | (60)                         | (73)     |
| Net cash provided by (used in) operating activities   | (72)                         | 48       |
| <b><u>Cash flows from investing activities:</u></b>   |                              |          |
| Restricted cash   | -                            | 183      |
| Purchase of property and equipment  | (25)                         | (4)      |
| Net cash used in investing activities   | (25)                         | 179      |
| <b><u>Cash flows from financing activities:</u></b>   |                              |          |
| Exercise of options of a director   | -                            | 160      |
| Net cash provided by financing activities   | -                            | 160      |
| Effect of exchange rate changes on cash and cash equivalents  | 30                           | 41       |
| Increase (decrease) in cash and cash equivalents  | (67)                         | 428      |
| Cash and cash equivalents at the beginning of the period  | 1,494                        | 1,409    |
| Cash and cash equivalents at the end of the period  | \$ 1,427                     | \$ 1,837 |

**Supplemental disclosure of non-cash activities:**



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|  |    |   |    |     |
|--|----|---|----|-----|
| Adjustments on account of change in accounting for uncertainties in income taxes | \$ | 6 | \$ | -   |
| Conversion of a convertible note   | \$ | - | \$ | 250 |

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, except share and per share data**

**NOTE 1:-**

**GENERAL**

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, sale and distribution of switching power supplies and converters. The Company has two reportable geographic segments - North America (sales through DPC) and Europe (sales through DPL).

**NOTE 2:-**

**SIGNIFICANT ACCOUNTING POLICIES**

a. The significant accounting policies applied in the annual financial statements of the Company as of December 31, 2006, are applied consistently in these financial statements. In addition, the following accounting policy is applied:

The accompanying unaudited consolidated financial statements as of June 30, 2007, and for the six months ended June 30, 2007 and 2006 are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management's discussion and analysis of the financial condition and results of operations, contained in the Company Annual Report on Form 10-KSB for the fiscal year ended December 31, 2006. The results of operations for the three and six months ended June 30, 2007, are not necessarily indicative of the results for the entire fiscal year ending December 31, 2007.

b. Accounting for stock-based compensation:

The Company has several stock-based employee compensation plans, which are described more fully in Note 5. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related Interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), "Share-Based Payment" ("SFAS 123(R)"), using the modified-prospective-transition method.

Under that transition method, compensation cost recognized in the first quarter of 2006 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). On December 31, 2005, the Company accelerated all of its unvested outstanding employees' stock options, and therefore, no compensation costs were included for share-based payments granted prior to January 1, 2006 in the first quarter of 2006.

**DIGITAL POWER CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Company and its subsidiaries apply SFAS 123 and Emerging Issues Task Force No. 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"), with respect to options issued to non-employees. SFAS 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

c. FIN 48, "Uncertainty in Income Taxes":

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement 109" ("FIN 48"). FIN 48 establishes a single model to address accounting for uncertain tax positions. FIN 48 clarified the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted the provisions of FIN 48 effective January 1, 2007. As a result of the implementation of FIN 48, the Company recorded an increase of \$ 6 associated with the liability for unrecognized tax benefits, which was accounted for as a reduction to the retained earnings balance as of January 1, 2007. There have been no changes to the unrecognized tax benefits during the current period.

**NOTE 3:- INVENTORIES**

|                                   | <b>June 30,<br/>2007<br/>Unaudited</b> |
|-----------------------------------|--|
| Raw materials, parts and supplies | \$ 174                                 |
| Work in progress                  | 295                                    |
| Finished products                 | 1,152                                  |
|                                   | <b>\$ 1,621</b>                        |

**NOTE 4:- ACCOUNTING FOR STOCK BASED COMPENSATION**

a. Share Option Plans:

1. Under the Company's stock option plans, options may be granted to employees, officers, consultants, service providers and directors of the Company or its subsidiaries.

**DIGITAL POWER CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands, except share and per share data**

2. As of June 30, 2007, the Company has authorized, by several Incentive Share Option Plans, the grant of options to officers, management, other key employees and others of up to 2,272,200 of the Company's Common shares. As of June 30, 2007, an aggregate of 648,715 of the Company's options are still available for future grant.

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## DIGITAL POWER CORPORATION

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 4:- ACCOUNTING FOR STOCK BASED COMPENSATION (Cont.)**

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 the terms of grant. Any options that are forfeited or cancelled before expiration become available for future grants.

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

|  | Amount<br>of options | Six months ended June 30, 2007           |   |                                    |
|--|----------------------|--|---|------------------------------------|
|  |                      | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>contractual<br>term (years) | Aggregate<br>intrinsic value<br>*) |
| Outstanding at the beginning of the period   | 901,225              | \$ 1.12                                  | 6.63  |                                    |
| Granted                                      | 100,000              | \$ 1.61                                  |   |                                    |
| Forfeited                                    | (20,035)             | \$ 1.12                                  |   |                                    |
| Outstanding at the end of the period         | 981,190              | \$ 1.17                                  | 6.49  | \$ 302,740                         |
| Exercisable options at the end of the period | 772,440              | \$ 1.08                                  | 5.75  | \$ 0.37                            |

\*) Calculation of aggregate intrinsic value is based on the share price of the Company's Common shares as of June 30, 2007 (\$ 1.33 per share).

Grants for the six months ended June 30, 2007:

Under the provisions of SFAS 123(R), the fair value of each option is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. Because Black-Scholes option valuation models incorporate various judgmental assumptions for inputs, those assumptions are disclosed. Expected volatility is based exclusively on historical volatility of the entity's stock as allowed by SFAS 123(R). The Company uses historical information with respect to the employee options exercised to estimate the expected term of options granted, representing the period of time that options granted are expected to be outstanding. The risk-free interest rate of period within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

## DIGITAL POWER CORPORATION

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 4:- ACCOUNTING FOR STOCK BASED COMPENSATION (Cont.)**

|                                   | <b>Six months ended<br/>June 30, 2007<br/>Unaudited</b> |
|-----------------------------------|---|
| Expected volatility               | 93.6%-107.1%  |
| Divided Yield                     | 0%  |
| Expected life of up to (in years) | 5-7   |
| Risk free interest rate           | 4.47%-5.09%   |

The fair value of options granted during the second quarter of 2007 was \$ 1.07.

As of June 30, 2007, there was \$ 184 of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the plan. That cost is expected to be recognized over a period of 4 years.

b. 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 has not distributed shares since 1998. As of June 30, 2007, the outstanding Common shares held by the ESOT amount to 167,504 shares.

**NOTE 5:- NET EARNINGS (LOSS) PER SHARE**

The following table sets forth the computation of the basic and diluted net earnings (loss) per share:

## 1. Numerator:

|   | <b>Six months ended<br/>June 30,</b> |             | <b>Three months ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|--|-------------|
|   | <b>2007</b>                          | <b>2006</b> | <b>2007</b>                            | <b>2006</b> |
|   | <b>Unaudited</b>                     |             |  |             |
| Net income (loss) available to<br>Common shareholders | \$ (155)                             | \$ 54       | \$ (196)                               | \$ 17       |

## 2. Denominator:

|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Denominator for basic net earnings per share of<br>weighted average number of Common shares | 6,610,708    | \$ 6,381,738 | \$ 6,610,708 | \$ 6,501,618 |
| Effect of dilutive securities:  |              |              |              |              |
| Employee stock options  | -            | 318,187      | -            | 494,669      |
| Convertible note  | -            | 169,025      | -            | 102,201      |
|   | \$ 6,610,708 | \$ 6,868,950 | \$ 6,610,708 | \$ 7,098,488 |

Denominator for diluted net earnings per  
Common share

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**DIGITAL POWER CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 6:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION**

The Company has two reportable geographic segments, see Note 1 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:

|   | <b>Six months ended June 30, 2007 (unaudited)</b> |                 |                     |                 |
|---|---|-----------------|---------------------|-----------------|
|   | <b>DPC</b>  | <b>DPL</b>      | <b>Eliminations</b> | <b>Total</b>    |
| Revenues  | \$ 2,314  | \$ 2,964        | \$ -                | \$ 5,278        |
| Intersegment revenues                               | 88  | -               | (88)                | -               |
| <b>Total revenues</b>                               | <b>\$ 2,402</b>                                   | <b>\$ 2,964</b> | <b>\$ (88)</b>      | <b>\$ 5,278</b> |
| Depreciation expense                                | \$ 9  | \$ 25           | \$ -                | \$ 34           |
| Operating income (loss)                             | \$ (230)  | \$ 55           | \$ -                | \$ (175)        |
| Financial income, net                               |   |                 |                     | \$ 29           |
| Net income (loss)                                   | \$ (211)  | \$ 65           | \$ -                | \$ (146)        |
| Expenditures for segment assets as of June 30, 2007 | \$ -  | \$ 25           | \$ -                | \$ 25           |
| Identifiable assets as of June 30, 2007             | \$ 2,212  | \$ 2,985        | \$ -                | \$ 5,197        |



## DIGITAL POWER CORPORATION

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 6:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)**

|   | Six months ended June 30, 2006 (unaudited) |          |              |          |
|---|--|----------|--------------|----------|
|   | DPC  | DPL      | Eliminations | Total    |
| Revenues  | \$ 2,861                                   | \$ 3,180 | \$ -         | \$ 6,041 |
| Intersegment revenues                               | 318  | -        | (318)        | -        |
| Total revenues                                      | \$ 3,179                                   | \$ 3,180 | \$ (318)     | \$ 6,041 |
| Depreciation expense                                | \$ 9                                       | \$ 30    | \$ -         | \$ 39    |
| Operating income                                    | \$ (31)                                    | \$ 97    | \$ -         | \$ 66    |
| Financial expenses, net                             |  |          |              | (12)     |
| Net income (loss)                                   | \$ (31)                                    | \$ 85    | \$ -         | \$ 54    |
| Expenditures for segment assets as of June 30, 2006 | \$ 2                                       | \$ 2     | \$ -         | \$ 4     |
| Identifiable assets as of June 30, 2006             | \$ 2,787                                   | \$ 3,514 | \$ -         | \$ 6,301 |

|   | Three months ended June 30, 2007 (unaudited) |          |              |          |
|---|--|----------|--------------|----------|
|   | DPC  | DPL      | Eliminations | Total    |
| Revenues  | \$ 1,111                                     | \$ 1,425 | \$ -         | \$ 2,536 |
| Intersegment revenues                               | 52   | -        | (52)         | -        |
| Total revenues                                      | \$ 1,163                                     | \$ 1,425 | \$ (52)      | \$ 2,536 |
| Depreciation expense                                | \$ 4   | \$ 11    | \$ -         | \$ 15    |
| Operating income (loss)                             | \$ (173)                                     | \$ (27)  | \$ -         | \$ (200) |
| Financial income, net                               |  |          |              | \$ 13    |
| Net income (loss)                                   | \$ (164)                                     | \$ (23)  | \$ -         | \$ (187) |
| Expenditures for segment assets as of June 30, 2007 | \$ -   | \$ 7     | \$ -         | \$ 7     |
| Identifiable assets as of June 30, 2007             | \$ 2,212                                     | \$ 2,985 | \$ -         | \$ 5,197 |

## DIGITAL POWER CORPORATION

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 6:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)**

|  | Three months ended June 30, 2006 (unaudited) |          |              |          |
|--|--|----------|--------------|----------|
|  | DPC  | DPL      | Eliminations | Total    |
| Revenues   | \$ 1,438                                     | \$ 1,895 | \$ -         | \$ 3,333 |
| Intersegment revenues                                  | 108  | -        | (108)        | -        |
| Total revenues   | \$ 1,546                                     | \$ 1,895 | \$ (108)     | \$ 3,333 |
| Depreciation expenses                                  | \$ 4   | \$ 15    | \$ -         | \$ 19    |
| Operating income (loss)                                | \$ (40)                                      | \$ 68    | \$ -         | \$ 28    |
| Financial expenses, net                                |  |          |              | \$ (11)  |
| Net income (loss)                                      | \$ (43)                                      | \$ 60    | \$ -         | \$ 17    |
| Expenditures for segment assets as of<br>June 30, 2006 | \$ 2   | \$ -     | \$ -         | \$ 2     |
| Identifiable assets as of June 30, 2006                | \$ 2,787                                     | \$ 3,514 | \$ -         | \$ 6,301 |

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

With the exception of historical facts stated herein, the matters discussed in this report are "forward looking" statements that involve risks and uncertainties that could cause actual results to differ materially from projected results. Such "forward looking" statements include, but are not necessarily limited to, statements regarding anticipated levels of future revenues and earnings from operations of the Company. Factors that could cause actual results to differ materially include, in addition to other factors identified in this report, dependence on the electronic equipment industry, competition in the power supply industry, dependence on manufacturers in China and other risks factors detailed in the Company's Form 10-KSB for the year ended December 31, 2006. Readers of this report are cautioned not to put undue reliance on "forward looking" statements that are, by their nature, uncertain as reliable indicators of future performance. The Company disclaims any intent or obligation to publicly update these "forward looking" statements, whether as a result of new information, future events, or otherwise.

### GENERAL

We are engaged in the business of designing, developing, manufacturing, marketing, selling and distributing switching power supplies to the industrial, telecommunication, and data communication, medical and military industries. Revenues are generated from sales to distributors, who will then resell our products to end customers who are often referred to as OEM's (original equipment manufactures) and direct sales to OEM's that may involve the use of manufacture representatives. Domestic refers to as revenue or operations that is principally in North America, while International refers to revenue or operations that is principally out of Europe. Domestically and in Europe, the company will sell to 'Commercial' customers who typically buy standard or modified standard product that are sellable to multiple customers while 'military' customers typically utilize highly custom power supplies that are typically not sellable to other customers.

We have continued our efforts to increase sales of our products to existing and new customers, and have continued our strategy to utilize our contract manufactures and our Design Partners contract manufactures in Asia. While we believe our revenues have increased to a sufficient amount to exceed our expenses, we may be subject to net losses in an individual quarter. We believe that our cash and cash equivalents will be sufficient to fund those losses for at least 12 months.

The Company's 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.

THREE AND SIX MONTHS ENDED JUNE 30, 2007, COMPARED TO JUNE 30, 2006

REVENUES

Total revenues for the Company decreased by 23.9% to \$2,536,000 for the three months ended June 30, 2007, from \$3,333,000 for the three months ended June 30, 2006. Revenue from the military products of the Company increased by 39.2% to \$963,000 for the three months ended June 30, 2007, from \$692,000 for the three months ended June 30, 2006. Revenue from the commercial products of the Company decreased by 40.4% to \$1,573,000 from \$2,641,000 for the three months ended June 30, 2006. The decrease in commercial product revenue is mainly attributed to end of life issues related to older standard product lines and timing issues while the increase in military product revenues is mainly attributed to new design wins.

Revenues from the domestic operations of the Company decreased by 22.7% to \$1,111,000 for the three months ended June 30, 2007, from \$1,438,000 for the three months ended June 30, 2006.

Revenues from the Company's European operations of DPL decreased 24.8% to \$1,425,000 for the three months ended June 30, 2007, from \$1,895,000 for the three months ended June 30, 2006. The decrease in the company's European operations is mainly attributed to timing issues with existing and new customers

For the six months ended June 30, 2007, revenues for the Company decreased by 12.6% to \$5,278,000 from \$6,041,000 for the six months ended June 30, 2006. The decrease in product revenue is mainly attributed to end of life issues related to older product lines and timing issues.

Revenues attributed to the domestic operations of the Company decreased by 19.1% to \$2,314,000 from \$2,861,000 for the six months ended June 30, 2006. The decrease in product revenue is mainly attributed to end of life issues related to older product lines and timing issues.

Revenues from the Company's European operations of DPL decreased by 6.8% to \$2,964,000 from \$3,180,000 for the six months ended June 30, 2006.

GROSS MARGINS

Gross margins decreased to 22.2% for the three months ended June 30, 2007, compared to 25.8% for the three months ended June 30, 2006. The decrease in gross margin is primarily due to \$140,000 write-off provision for obsolete inventory from the Company's European operations. Gross margins decreased to 25.4% for the six months ended June 30, 2007 compared to 27.2% for the six months ended June 30, 2006 the decrease is primarily due to write-off provision for obsolete inventory from the Company's European operation.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 7.1% of revenues for the three months ended June 30, 2007, compared to 5.2% for the three months ended June 30, 2006. In actual dollars this increase is primarily due to the decrease in revenues from quarter to quarter as engineering and product development expenses expenditures remained at approximately the same level for such periods. Engineering and product development expenses were 7.6% of revenues for the six months ended June 30, 2007, compared to 5.1% of revenues for the six months ended June 30, 2006. This increase is primarily due to the decrease in revenues from quarter to quarter. However, engineering and product development expenses also increased in actual dollar expenditures by \$92,000 primarily due to increases in safety and consulting expenditures.

## SELLING AND MARKETING

Selling and marketing expenses were 9.8% of revenues for the three months ended June 30, 2007, compared to 9.5% for the three months ended June 30, 2006. In absolute dollars, the selling and marketing expenditures decreased by \$66,000 primarily due to a decrease in salary and consulting expenses. Selling and marketing expenses were 9.1% of revenues for the six months ended June 30, 2007, compared to 10.2% for the six months ended June 30, 2006. Actual dollar expenditures decreased by \$139,000 primarily due to decrease in salary and consulting expenses.

## GENERAL AND ADMINISTRATIVE

General and administrative expenses were 13.2% of revenues for the three months ended June 30, 2007, compared to 10.4% for the three months ended June 30, 2006. General and administrative expenses were 12.0% of revenues for the six months ended June 30, 2007, compared to 10.8% for the six months ended June 30, 2006. Actual dollar expenditures remained approximately at the same level.

## FINANCIAL INCOME AND EXPENSES

Financial income net was \$13,000 for the three months ended June 30, 2007, compared to financial expense net of \$11,000 for the three months ended June 30, 2006. Financial income was \$29,000 for the six months ended June 30, 2007, compared to financial expenses of \$12,000 for the six months ended June 30, 2006. Financial income resulted mainly from interest income received.

## NET INCOME (LOSS)

For the three months ended June 30, 2007, the Company had net loss of \$196,000 compared to net income of \$17,000 for the three months ended June 30, 2006. Net loss is mainly due to provision for obsolete inventory and reduction in revenues. Net loss for the six months ended June 30, 2007 was \$155,000 compared to net income of \$54,000 for the six months ended June 30, 2006. Net loss is mainly due to the provision for obsolete inventory and reduction in revenues.

## LIQUIDITY AND CAPITAL RESOURCES

On June 30, 2007, the Company had cash, cash equivalents \$1,427,000 and working capital of \$3,254,000. This compares with cash and cash equivalents of \$1,837,000 and working capital of \$3,056,000 at June 30, 2006. The increase in working capital is mainly due to a decrease in accounts payable and related parties trade payables, offset partially by decrease in cash and accounts receivable.

Cash used by operating activities for the Company totaled \$72,000 for the six months ended June 30, 2007, compared to cash provided from operating activities of \$48,000 for the six months ended June 30, 2006. Cash used by operating activity was mainly due to a decrease in accounts payable and related parties trade payables due to timing differences and net loss, offset partially by decrease in accounts receivable due to increase effort on collection. Cash used by investing activities was \$25,000 for the six months ended June 30, 2007, compared to cash provided in investing activities of \$179,000 for the six months ended June 30, 2006. The cash used by investing activities was mainly for purchase of equipment.

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 shareholder's equity.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

None.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS

Exhibits

- |      |  |
|------|--|
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                           |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                           |
| 32.1 | Certification of the Chief Executive Officer & Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DIGITAL POWER CORPORATION  
(Registrant)

Date: August 15, 2007

/s/ Jonathan Wax

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Jonathan Wax,  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 15, 2007

/s/ Leo Yen

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Leo Yen,  
Chief Financial Officer  
(Principal Financial Officer)