

DIGITAL POWER CORP  
Form 10KSB  
April 02, 2007

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**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, 2006**  
Commission File Number 1-12711

**DIGITAL POWER CORPORATION**

*(Name of small business issuer in its charter)*

**California**

**3679**

**94-1721931**

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

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*(Primary Standard Industrial  
Classification Code)*

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*(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**

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Common Stock

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American Stock Exchange

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

**Title of Each Class**

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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, 2006, were \$12,631,000.

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As of March 1, 2007, the aggregate market value of the voting common stock held by non-affiliates was approximately \$5,638,289 based on the closing price of \$ 1.59 per share.

As of March 1, 2007, the number of shares of common stock outstanding was 6,610,708.

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.

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DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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As used in this annual report, the terms we, us, our, 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 downturn, and our dependence on our manufacturing subcontractor, primarily in China. All these 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 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 ( DPC ) designs, develops, manufactures, markets, sells, private licenses and distributes 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 services 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, sells and distributes products for the European marketplace, 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. The Company moved most of its production to Asian subcontractors, offering lower prices with shorter lead-times, and to Telkoor Telecom Ltd. ( Telkoor ), an Israeli Company which holds 43.8% of the outstanding shares of DPC. Telkoor manufactures at longer lead times and at higher total costs in comparison to the Digital Power manufacturing partners. Telkoor also utilizes an increasing percentage of Asian subcontractors.

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 direct current (DC); (ii) dividing a single input voltage into distinct and isolated output voltages; and (iii) 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 and commonly referred to as AC/DC 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 converters. Switching power supplies are distinguished from linear power supplies by the manner and efficiency with which the power supplies step 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 voltage 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 than the linear power supply typically, 75% efficient for a 5V output regulator.

One of the great advantages of switching power supplies and our designs, which we secure through Telkooor, in addition to their higher efficiency, is their high power density, or power-to-volume ratio, making them smaller than those 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 economically 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 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 that 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.

#### **Telkooor Telecom Ltd.**

Telkooor, our major shareholder, is a corporation organized and headquartered in Israel. It is primarily engaged in developing, marketing, and selling power supplies and power systems for the Commercial and Military Markets. Consistent with our total cost reduction efforts, and taking advantage of Telkooor's strong engineering team, we have and will continue to utilize Telkooor to assist us in new product development. Further, during the year ended December 31, 2006, we made significant progress in penetrating the United States and European markets with Telkooor's products. This effort generated sales of approximately 48% of our revenues for 2006. We intend to continue to sell Telkooor's products in the future to supplement our line of products.

## Digital Power Limited

Digital Power Limited, organized and 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. Frequency converters manufactured by DPL are used to convert a naval 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 the starting and servicing of helicopters on naval vessels, and DPL now supplies these as part of overall helicopter start and servicing systems. DPL products add diversity to our product line, provide greater access to the United Kingdom and European markets, and strengthen our engineering and technical resources. For the year ended December 31, 2006, DPL contributed approximately 53% to our gross revenues.

## The Market

Geographically, we serve primarily the North American power electronics market with individual AC/DC power supplies and DC/DC converters ranging from 50 watts to 1,200 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 in North America and Europe primarily 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 the military. We have a current base of approximately 400 active customers, some of which are served through our distributors.

DPL military products are sold primarily in the UK and in Europe.

## Strategy

Our strategy is to be the supplier of choice to OEMs requiring high-quality power solutions where power density (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 and high density power supplies allow customers a more effective choice between our products and products offered by other power supply competitors. Our flexibility and high density series is designed around a standardized power platform but 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 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 in-house 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 and high density power supplies, we believe we have an advantage over our competitors.

## Products and Products Strategy

We have eleven 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. Simply changing the power transformer construction and a small number of output components can produce a broad range of output ratings, from 2.0 volts to 48 volts. 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 and high density concept applies to all of our EF175/200, EF300/400, CPCI, Strongbox, US, UP/SP, DP, and UPF product series. Generally a common printed circuit board is usually 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 is: the eF s series, CPCI s series, Strong Box series, and custom products.

The new 3.6KW Strongbox® is a single output front end with I<sup>2</sup>C data bus. It features 3 x 1200 watt cassettes. The Strongbox is available in 24V and 48V outputs with active power factor correction.

The EF series are high-density open frame power supplies, which most commonly come in 12, 24 and 48 volt options with power factor correction.

The CPCI series are high-density enclosed central power supplies, which most commonly come in 5, 12, 24, and 48-volt options with 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 inputs allow them to be used worldwide without jumper selection. Flexibility options include power good signal, an isolated V4 output, and UL544 (2<sup>nd</sup> 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. 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 (2<sup>nd</sup> 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 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 (2<sup>nd</sup> 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".

#### **DPL 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 40kVA.

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

Transformer Rectifiers 28V at up to 400A. Ratings of 10 and 15kVA provide DC power to enable the ship to start and service helicopters. Gresham's Transformer Rectifiers (TRUs) are in service with a number of Navies, including the Royal Navy. The scope of supply has now been expanded so that Gresham can supply entire helicopter start and servicing systems covering a wide range of aircraft.

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

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 switch mode 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.

DPL 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.

### **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 principal source in the Far East is Winco Power Technology ( Winco ). In coordination with Telkoo, we also interface with three additional contract manufacturers in China who support Telkoo.

We have contract manufacturing relationships with Winco 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, 2006, Digital Power purchased approximately 31.5% of its power supply requirements through Winco. Our products are meeting the certification standards according to independent safety agency requirements.

### **Regulatory Requirements**

Digital Power and its manufacturing partners are required to meet applicable regulatory, environmental, emissions, safety or other requirements where specified by the customer and accepted by Digital Power or as required by local regulatory or legal requirements. In July of 2006, the industry began phasing in RoHs and Wee requirements in most geographical markets with specific emphasis on consumer based products. These requirements may require the use of new components or finish goods to be built with RoHs and Wee compliant components potentially rendering existing or down revision finish goods inventory and component inventory to risk of obsolescence. In addition, there is some speculation that RoHs and Wee compliant components may be subject to longer lead-times and higher prices in the near term as the industry transitions to these new requirements.

### **Digital Power Limited Manufacturing**

DPL 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 China. Full assembly, test, and quality assurance take 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 functions, such as Engineering and Administration.

### **Sales and Marketing**

Digital Power markets its products through a network of independent manufacturer's representatives and distributors. Each representative organization is responsible 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 shipment. Typically, either the representative organization or Digital Power may terminate the agreement with 30 days written notice.

We have terminated most of our distributor's agreements, and we continue to sell directly to our customers.

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, 2006, our warranty reserve was \$69,000.

### **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 whom may offer products comparable in quality to ours. Many of our competitors including Power One, Emerson (Astec) Technologies, Inc., Lambda Electronics, and Mean-Well 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 with our customers. We also face competition from current and prospective customers who may decide to design and manufacture internally 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 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 believes that we must continue to compete favorably on the basis of value by providing reliable manufacturing, offering customer service 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 is no assurance that we will continue to successfully compete 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, adaptability, and efficiency, while we attempt to anticipate changing market demands for increased functionality, such as PFC and improved EMI filtering.

The Company partners with various design and contract engineering firms for development of its new products supported by its internal engineering services staff. The Company intends to continue its strategy for engineering and development.

## Employees

As of December 31, 2006, Digital Power had 33 employees located in the United States and the United Kingdom.

## Foreign Currency Fluctuations

DPL operates 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 year ended December 31, 2006, we recorded a foreign currency translation profit of \$223,000. For the year ended 2005, we recorded a foreign currency translation loss adjustment of \$132,000.

## 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 allow our subcontractors to purchase components based on orders received or forecasts to minimize our risk of unusable inventory. To the extent necessary, we may allow them to procure materials prior to orders received to obtain shorter lead times and to achieve quantity discounts following a risk assessment. (See regulatory requirements).

## 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.

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, 2006, we paid rent for the months from January to September at \$9,025 per month. As of October 1, 2006, our rent increased to \$9,500 per month and will remain at that rate until the expiration of the lease agreement on September 30, 2007. During 2002, we issued the landlord warrants to purchase 10,000 shares of Common Stock at an exercise price of \$1.00 per share 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, 2009. We believe that our existing facilities are adequate for the immediate future and have no plans to expand them. However, both locations are actively evaluating utilization of smaller facilities in order to reduce expenditures

## ITEM 3. LEGAL PROCEEDINGS.

The Company has submitted a claim for an unpaid debt of \$82,799.63 for products sold to Zultys Technologies. Zultys Technologies filed for bankruptcy protection following its failure to pay for the goods the Company had delivered. The Company is represented by counsel in the bankruptcy proceedings. Except for these proceedings, the Company is not currently involved in any legal proceedings.

**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 stock 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 stock for the prior two fiscal years.

Quarter Ended	High	Low
12/31/2006	\$ 1.30	\$ 1.27
09/30/2006	1.35	1.33
06/30/2006	1.69	1.50
03/31/2006	1.88	1.79
12/31/2005	\$ 0.89	\$ 0.82
09/30/2005	1.07	0.90
06/30/2005	0.61	0.56
03/31/2005	0.86	0.85

## (b) Holders

As of March 1 2007, there were shares of our common shares outstanding, held by approximately 121 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.

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

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

During the year ended December 31, 2006, the Company's products were received well in the marketplace. We have continued our promotional efforts to increase sales to existing and new customers and continue our strategy to move the manufacturing of our products to the Far East. While we believe our revenues have increased to a sufficient amount to offset our expenses, we may be subject to net losses in an individual quarter. We believe that our cash will be sufficient to fund those losses for at least 12 months.

**Results of Operations**

The table below sets forth certain statements of operations data as a percentage of revenues for the years ended December 31, 2006, and 2005:

	Years Ended December 31,	
	2006	2005
Revenues	100.00%	100.00%
Cost of Revenues	73.45	70.33
Write-off of excess inventory	0.57	0.94
<b>Gross profit</b>	<b>25.98</b>	<b>28.73</b>
Engineering and product development	5.25	5.38
Sales and marketing	9.21	12.05
General and administrative	10.61	10.25
<b>Total operating expenses</b>	<b>25.07</b>	<b>27.68</b>
<b>Operating income (loss)</b>	<b>0.91</b>	<b>1.05</b>
Financial income (expenses)	0.12	(0.81)
<b>Net Income (loss)</b>	<b>1.03</b>	<b>0.24</b>

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, 2006, compared to Year Ended December 31, 2005.

**Revenues**

For the year ended December 31, 2006, revenues increased by 16.4% to \$12,631,000 from \$10,856,000 for the year ended December 31, 2005. The increase in revenue is mainly due to increase in sales of new products.

Revenues from the domestic operation of DPC increased 19.6% to \$5,919,000 for the year ended December 31, 2006, from \$4,947,000 for the year ended December 31, 2005. Revenues from the Company's European operations of DPL increased 13.6% to \$6,712,000 for the year ended December 31, 2006, from \$5,909,000 for the year ended December 31, 2005. The increase in revenues for the year ended December 31, 2006, from the year ended December 31, 2005 is due to increase in sales of our high density product lines.

**Gross Margins**

Gross margins were 25.98% for the year ended December 31, 2006, compared to 28.73% for the year ended December 31, 2005. The decrease in our gross margins is mainly a result of product mix and a larger percentage of products built in higher cost manufacturing locations (Israel).

**Engineering and Product Development**

Engineering and product development expenses were 5.25% of revenues for the year ended December 31, 2006, compared to 5.38% for the year ended December 31, 2005. Actual dollar expenditures increased by \$79,000 mainly due to product safety expenditures.

### **Selling and Marketing**

Selling and marketing expenses were 9.21% of revenues for the year ended December 31, 2006, compared to 12.05% for the year ended December 31, 2005. Actual dollar expenditures decreased by \$145,000 mainly due to headcount reduction.

### **General and Administrative**

General and administrative expenses were 10.61% of revenues for the year ended December 31, 2006, compared to 10.25% for the year ended December 31, 2005. In actual dollars, general and administrative expenses increased by \$227,000 mainly due to bad debt reserve, legal expenses and contract services.

### **Financial Income (expense), net**

Net financial income was \$15,000 for the year ended December 31, 2006, compared to net financial expenses of \$88,000 for the year ended December 31, 2005. The financial expense resulted mainly from the exchange rate fluctuation of the Company's United Kingdom's operations of DPL.

### **Net Income (loss)**

Net income for the year ended December 31, 2006 was \$131,000 compared to a net income of \$26,000 for the year ended December 31, 2005. The net income is mainly due to increase in revenue.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 is 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 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 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 North America and Europe. 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 of 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.

### **Equity-based compensation expense:**

We account for equity-based compensation in accordance with SFAS No. 123(R), Share-Based Payment. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as an expense over the requisite service periods. Determining the fair value of share-based awards at the grant date requires the exercise of judgment, including the amount of share-based awards that are expected to be forfeited. If actual results differ from these estimates, equity-based compensation expense and our results of operations could be impacted.

### **Liquidity and Capital Resources**

On December 31, 2006, we had cash, cash equivalents, and restricted cash of \$1,597,000, and working capital of \$3,309,000. This compares to cash, cash equivalents, and restricted cash of \$1,688,000 and working capital of \$2,412,000 on December 31, 2005. The increase in working capital is mainly due to decrease in accounts payable and related parties trade payables and increase in trade receivable.

Net cash used in operating activities was \$358,000 for the year ended December 31, 2006, compared to \$24,000 in cash used in operating activities for the year ended December 31, 2005. Cash used in operating activities was mainly due to decrease in accounts payables and in related parties trade payables account, and increase in trade receivable.

Net cash provided by investing activities was \$150,000 for the year ended December 31, 2006, compared to \$103,000 cash used by investing activities for the year ended December 31, 2005. The cash provided by investing activity was mainly due to release of restricted cash.

Net cash provided by financing activities was \$162,000 for the year ended December 31, 2006, compared to \$250,000 net cash provided by financing activities for the year ended December 31, 2005. Cash provided by financing activities was mainly due to exercise of options.

We do not believe that our sales are seasonal. Furthermore, 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.

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. On February 8, 2006 Telkooor issued to the Company a Notice of Conversion under the terms of a convertible note representing a loan from Telkooor to the company, for 235,849 common shares of the Company. In April 2006, the entire amount of the convertible note was converted into 235,849 Common shares. There is no amount due on the note after the conversion.

## **RISK FACTORS**

In addition to the other information presented in this report, the following should be considered carefully in evaluating our business and us. 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 profit during the year ended December 31, 2006, and we anticipate similar performance in 2007. However, certain quarters may be subject to net losses.

For the year ended December 31, 2006, we incurred an operating profit of \$116,000. 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 by Digital Power and its engineering partners

### **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 Electronic Equipment Industries.**

Substantially, all of our existing customers are in the 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 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.

### **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. Furthermore, 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.

**Patents do not protect our products.**

Our products are not registered in the U.S. or elsewhere as 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 competitors or former employees will not 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 a shareholder's percentage of ownership. As of December 31, 2006, the Company has employees' options to purchase 901,225 shares of common stock, with a weighted average exercise price of \$1.12 exercisable at prices ranging from \$0.48 to \$3.03 per share, and consultants' and service providers' options and warrants to purchase 230,000 shares of common shares, with a weighted average exercise price of \$1.11 exercisable at prices ranging from \$0.55 to \$1.19



**DIGITAL POWER CORPORATION**  
**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2006**

**IN U.S. DOLLARS**

**INDEX**

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**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, 2006 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, 2006. 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 were 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, 2006 and the consolidated results of their operations and cash flows for the two years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 21 to the consolidated financial statements, in 2006 the Company adopted Financial Accounting Standard No. 123 (Revised 2004) Share-Based Payment .

Tel-Aviv, Israel  
March 7, 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)

	December 31, 2006
<b>ASSETS</b>	
<b>CURRENT ASSETS:</b>	
Cash and cash equivalents	\$ 1,494
Restricted cash	103
Trade receivables, net of allowance for doubtful accounts of \$103	2,206
Prepaid expenses and other receivables	140
Inventories (Note 3)	1,599
<b>Total</b> current assets	<b>5,542</b>
PROPERTY AND EQUIPMENT, NET (Note 4)	162
<b>Total</b> assets	<b>\$ 5,704</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>	
<b>CURRENT LIABILITIES:</b>	
Accounts payable	\$ 715
Related parties - trade payables (Note 12)	990
Deferred revenues	89
Other current liabilities (Note 6)	439
<b>Total</b> current liabilities	<b>2,233</b>
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)</b>	
<b>SHAREHOLDERS EQUITY (Note 8):</b>	
Share capital:	
Series A redeemable, convertible Preferred shares, no par value: 500,000 shares authorized, 0 shares issued and outstanding as of December 31, 2006	
Preferred shares, no par value: 1,500,000 shares authorized, 0 shares issued and outstanding as of December 31, 2006	
Common shares, no par value: 30,000,000 shares authorized; 6,610,708 shares issued and outstanding as of December 31, 2006	
Additional paid-in capital	13,768
Accumulated deficit	(10,463)
Accumulated other comprehensive income	166
<b>Total</b> shareholders equity	<b>3,471</b>
<b>Total</b> liabilities and shareholders equity	<b>\$ 5,704</b>

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

## DIGITAL POWER CORPORATION

## CONSOLIDATED STATEMENTS OF INCOME

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

	Year ended December 31,	
	2006	2005
Revenues (Note 12)	\$ 12,631	\$ 10,856
Cost of revenues	9,277	7,635
Write-off of excess inventory	72	102
Gross profit	3,282	3,119
Operating expenses:		
Engineering and product development	663	584
Selling and marketing	1,163	1,308
General and administrative	1,340	1,113
Total operating expenses	3,166	3,005
Operating income	116	114
Financial income (expenses), net	(15)	(88)
Net income	\$ 131	\$ 26
Basic net earnings per share	\$ 0.020	\$ 0.004
Diluted net earnings per share	\$ 0.019	\$ 0.004

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

## DIGITAL POWER CORPORATION

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

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

	Common shares Number	Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Other accumulated comprehensive income (loss)	Total comprehensive (loss income)	Total shareholders equity
Balance as of January 1, 2005	6,161,859	\$ 13,263	\$ (13)	\$ (10,620)	\$ 75		\$ 2,705
Stock compensation related to options granted to Telkooor s employees		8					8
Amortization of deferred stock compensation related to options granted to an employee			13				13
Stock compensation related to acceleration of employees stock options		4					4
Comprehensive loss:							
Net income				26		\$ 26	26
Foreign currency translation adjustments					(132)	(132)	(132)
<b>Total comprehensive loss</b>						<b>\$ (106)</b>	
Balance as of December 31, 2005	6,161,859	13,275		(10,594)	(57)		2,624
Stock compensation related to options granted to Telkooor s employees and other consultant		52					52
Stock compensation related to options granted to employees		29					29
Exercise of options granted to a director and employees	213,000	162					162
Conversion of convertible note	235,849	250					250
Comprehensive income:							
Net income				131		131	131
Foreign currency translation adjustments					223	223	223
<b>Total comprehensive income</b>						<b>\$ 354</b>	
Balance as of December 31, 2006	6,610,708	\$ 13,768	\$	\$ (10,463)	\$ 166		\$ 3,471

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

	Year ended December 31,	
	2006	2005
<b>Cash flows from operating activities:</b>		
Net income	\$ 131	\$ 26
Adjustments required to reconcile net income to net cash used in operating activities:		
Depreciation	75	90
Stock compensation related to options granted to employees	29	13
Stock compensation related to options granted to Telkooor s employees and other consultant	52	12
Increase in trade receivables	(230)	(273)
Decrease in prepaid expenses and other receivables	13	35
Increase in inventories	(28)	(75)
Increase (decrease) in accounts payable and related parties - trade payables	(301)	230
Decrease in deferred revenues and other current liabilities	(99)	(82)
<b>Net cash used in operating activities</b>	<b>(358)</b>	<b>(24)</b>
<b>Cash flows from investing activities:</b>		
Restricted cash, net	176	(48)
Purchase of property and equipment	(26)	(55)
<b>Net cash provided by (used in) investing activities</b>	<b>150</b>	<b>(103)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of convertible note		250
Proceeds from exercise of options	162	
<b>Net cash provided by financing activities</b>	<b>162</b>	<b>250</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>131</b>	<b>(37)</b>
<b>Increase in cash and cash equivalents</b>	<b>85</b>	<b>86</b>
Cash and cash equivalents at the beginning of the year	1,409	1,323
<b>Cash and cash equivalents at the end of the year</b>	<b>\$ 1,494</b>	<b>\$ 1,409</b>
<b>Supplemental disclosure of cash flows activities:</b>		
Interest paid	\$ 2	\$ 2

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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 and Digital Power Limited ( DPL ), a wholly owned subsidiary located in the United Kingdom, 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 Telkoor Telecom Ltd. ( Telkoor ), a major shareholder of the Company and one of DPC s third party subcontractor for manufacturers capabilities in the producing of the products which DPC sells. If these manufacturers are unable or unwilling to continue manufacturing the Company s products in required volumes on a timely basis, that could lead to loss of sales, and adversely affect operating results and cash position. The Company also depends on Telkoor s intellectual property and ability to transfer production to third party manufacturers. Failure to obtain new products in a timely fashion or delay in transferring to third party low cost subcontract manufacturers will have an adverse effect on the ability of the Company to successfully deliver products. See also Note 12.

**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:

All of the revenues of the Company are generated in U.S. dollars ( dollar ). In addition, a substantial portion of the costs of the Company and its subsidiaries are incurred in dollars. The Company s management believes that the dollar is the currency of the primary economic environment in which the Company operates.

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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## U.S. dollars in thousands

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

## 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.

## e. Restricted cash:

Restricted cash is held on account of letter of credit issued by the Company's bank and in respect of future lease payment and for certain customers until the guarantee expires. The restricted cash is invested in a deposit.

## f. Inventories:

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 2006 and 2005, the Company recorded inventories write-offs in a total amount of \$72 and \$102, 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 or the life of the asset, whichever is earlier



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

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

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 2006 and 2005, no impairment losses have been identified.

## h. Revenue recognition:

The Company and its subsidiary generate their revenues from the sale of their product through the direct and indirect sales force.

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. However, 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. Revenues subject to stock rotation rights are deferred until the products are sold to the end customer or until the rotation rights expire.

Service revenues are deferred and recognized on a straight-line basis over the term of the service agreement. Service revenues are immaterial to the Company's revenues.

## 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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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

**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 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.

A tabular reconciliation of the changes in the company's aggregate product warranty liability was not provided due to the immateriality.

## l. Accounting for stock-based compensation:

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R).

Effective January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective transition method. Under that transition method, compensation cost recognized in the year ended December 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) 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 No. 123(R). Results for prior periods have not been restated, in accordance with the modified prospective transition method.

As a result of adopting SFAS No. 123(R) on January 1, 2006, the Company's net loss for the year ended December 31, 2006, is \$29 lower than if it had continued to account for share-based compensation under APB 25. Basic and diluted net loss per share for the year ended December 31, 2006, are \$0.005 and \$0.004, respectively lower than if the Company had continued to account for share based compensation under APB 25.

SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements. Prior to the adoption of SFAS No. 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). Under the intrinsic value, equity-based compensation recognized for the year ended December 31, 2005, was \$17.

## DIGITAL POWER CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123(R) to options granted under the Company's stock option plans in all periods presented. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' vesting periods.

	Year ended December 31, 2005
Net income as reported	\$ 26
Add: stock-based compensation expenses included in the reported net income	17
Deduct: Total stock-based compensation expenses determined under fair value based method for all awards	*) (406)
Pro forma net loss	\$ (363)
Earnings (loss) per share	
Basic net earnings per share- as reported	\$ 0.004
Basic net loss per share - pro forma	\$ (0.06)
Diluted net earning per share- as reported	\$ 0.004
Diluted net loss per share- pro forma	\$ (0.06)

\*) On December 21, 2005, the Company accelerated all of its unvested outstanding employees' stock options. See also Note 8c.

The fair value for options granted prior to January 1<sup>st</sup>, 2006 was estimated at the date of grant using the Black and Scholes option pricing model based on the following weighted-average assumptions:

	2005
Dividend yield	0%
Expected volatility	103%
Risk-free interest rate	4-4.6%
Expected life (years)	3-7

The Company estimates the fair value of stock options granted under SFAS No. 123(R) using the Black-Scholes option-pricing model that uses the assumption as follows:

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

Expected volatility is based on historical volatility that is representative of future volatility over the expected term of the options. The expected term of options granted represents the period of time that options granted are expected to be outstanding, and was determined based on the simplified method in accordance with SAB 107. The risk free interest rate is based on the yield of U.S Treasury bonds with equivalent terms. The dividend yield is based on the Company's historical and future expectation of dividends payouts. The Company has not paid cash dividend historically and has no foreseeable plans to pay cash dividends in the future.

The Company recognizes compensation expense based on awards ultimately expected to vest, net of estimated forfeitures at the time of grant. Estimated forfeitures are based on historical pre-vesting forfeitures. SFAS 123(R) requires forfeitures to be estimated and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The fair value for options granted in 2006 is amortized over their vesting period using a straight-line recognition method and estimated at the date of grant with the following assumptions:

	<b>2006</b>
Dividend yield	0%
Expected volatility	93.6 - 107.1%
Risk-free interest	4.5% - 5.03%
Forfeiture rate	5%
Expected life of up to	5 - 7 years

The Company's aggregate compensation cost for the year ended December 31, 2006, totaled \$29.

The total equity-based compensation expense related to all of the Company's equity-based awards, recognized for 12 months ended December 31, 2006, was comprised as follows:

	<b>Year ended December 31, 2006</b>
Cost of goods sold	\$ 2
Research and development	3
Sales and Marketing	9
General and administrative	15
<b>Total equity-based compensation expense</b>	<b>\$ 29</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

A summary of option activity under the Company's Stock Option Plans as of December 31, 2006, and changes during year then ended are as follows:

	Year ended December 31, 2006			
	Amount of options	Weighted Average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at the beginning of the year	1,009,225	\$ 1.01		
Granted	145,000	\$ 1.38		
Exercised	(213,000)	\$ 0.76		
Forfeited	(40,000)	\$ 0.99		
Outstanding at the end of the year	901,225	\$ 1.12	6.63	\$ 0.33
Vested or expected to vest at year end	873,225			
Exercisable options at the end of the year	761,225	\$ 1.07	6.14	\$ 0.36

The weighted-average grant-date fair value of options granted during the year ended December 31, 2006, was \$1.18. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of fiscal 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes based on the fair market value of the Company's shares. The total intrinsic value of options exercised during the year ended December 31, 2006, was \$106.

As of December 31, 2006, there was \$107 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the company's stock option plans. That cost is expected to be recognized over a weighted average period of 3.27 years. The total fair value of options vested during the year ended December 31, 2006, was \$0.

The Company applies SFAS No. 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 and warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the options and warrants at the date of grant.

## 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:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

## 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 254,037 options and 638,392 options for the years ended December 31, 2006, and 2005, respectively.

## 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, and 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 July 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies 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 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

FIN 48 applies to all tax positions related to income taxes subject to the Financial Accounting Standard Board Statement No. 109, Accounting for income taxes ( FAS 109 ). This includes tax positions considered to be routine as well as those with a high degree of uncertainty.

FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 will be reported as an adjustment to the opening balance of retained earnings.

The Company is currently evaluating the effect of the adoption of FIN 48 on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. The statements does not apply to accounting standard that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This statement provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The Standard s objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. This Statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 159.

## NOTE 3:- INVENTORIES

	December 31, 2006
Raw materials, parts and supplies	\$ 309
Work in progress	317
Finished products	973
	<u>\$ 1,599</u>



## DIGITAL POWER CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

## NOTE 4:- PROPERTY AND EQUIPMENT

	December 31, 2006
Cost:	
Computers, software and related equipment	\$ 1,074
Office furniture and equipment	201
Leasehold improvements	423
	<u>1,698</u>
Accumulated depreciation	
Computers, software and related equipment	1,018
Office furniture and equipment	198
Leasehold improvements	320
	<u>\$ 1,536</u>
Depreciated cost	<u>\$ 162</u>

## NOTE 5:- CONVERTIBLE NOTE

In January 2005, the Company entered into a convertible note agreement with Telkooor, a major shareholder, according to which Telkooor extended 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 was convertible at any time into Common shares at a rate of \$1.06 per share, which is equal to the quoted market price of the Company's Common stock on the date the note was approved and signed. In accordance with the guidelines of APB No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Instruments, and EITF Issue No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, the Company has determined that the note had no beneficial conversion feature since the conversion price was equal to the quoted market price of the Company's Common shares at the date the note was approved and signed.

In April 2006, the entire amount of the convertible note was converted into 235,849 Common shares.

## NOTE 6:- OTHER CURRENT LIABILITIES

	December 31, 2006
Accrued payroll and payroll taxes	\$ 97