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DIGITAL POWER CORP
Form 10QSB
November 15, 2004

UNITED STATES
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 September
30, 2004

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 94-1721931

(State or other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

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

Number of shares of common stock outstanding as of November 10, 2004: 6,136,859

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DIGITAL POWER CORPORATION

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INTERIM CONSOLIDATED FINANCIAL STATEMENTS

AS OF SEPTEMBER 30, 2004

IN U.S. DOLLARS

UNAUDITED

INDEX

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DIGITAL

CONSOLIDATED BALANCE SHEET

U.S. dollars in thousands

ASSETS

CURRENT ASSETS:

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Cash and cash equivalents
Restricted cash
Trade receivables, net of allowance for doubtful accounts of \$61 at September 30, 2004
Prepaid expenses and other current assets
Inventories

Total current assets

LONG-TERM LEASE DEPOSITS

PROPERTY AND EQUIPMENT, NET

Total assets

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

DIGITAL

CONSOLIDATED BALANCE SHEET

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

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:

Accounts payable
Other current liabilities

Total current liabilities

SHAREHOLDERS' EQUITY:

Series A redeemable, convertible Preferred shares, no par value: 500,000 shares authorized,
0 shares issued and outstanding at September 30, 2004
Preferred shares, no par value: 1,500,000 shares authorized, 0 shares issued and outstanding a
September 30, 2004
Common shares, no par value: 10,000,000 shares authorized; 6,136,859 shares issued and

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outstanding at September 30, 2004
 Additional paid-in capital
 Deferred stock compensation
 Accumulated deficit
 Accumulated other comprehensive income

Total shareholders' equity

Total liabilities and shareholders' equity

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

CONSOLIDATED STATEMENTS OF OPERATIONS

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

| | Nine months ended September 30, | | |
|-------------------------------------|------------------------------------|----------|----------|
| | 2004 | 2003 | 2002 |
| | Unaudited | | |
| Revenues | \$ 6,158 | \$ 5,338 | \$ 4,811 |
| Cost of revenues | 4,673 | 3,883 | 3,411 |
| Gross profit | 1,485 | 1,455 | 1,400 |
| Operating expenses: | | | |
| Engineering and product development | 449 | 384 | 384 |
| Selling and marketing | 947 | 784 | 784 |
| General and administrative | 811 | 946 | 946 |
| Total operating expenses | 2,207 | 2,114 | 2,060 |
| Operating loss | (722) | (659) | (660) |
| Financial income (expenses), net | (5) | 12 | 12 |
| Other expenses | (6) | - | - |

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| | | | |
|---|-----------|-----------|-------|
| Loss before income taxes | (733) | (647) | |
| Income taxes | - | (73) | |
| | ----- | ----- | ----- |
| Net loss | \$ (733) | \$ (574) | \$ |
| | ===== | ===== | ===== |
| Basic and diluted net loss per share | \$ (0.13) | \$ (0.11) | \$ |
| | ===== | ===== | ===== |
| Weighted average number of shares used in computing basic and diluted net loss per share | 5,772,868 | 5,110,680 | 6,12 |
| | ===== | ===== | ===== |

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

| | Common shares | | Additional | Deferred | Accumulated | othe |
|---|---------------|-----------|------------|--------------|-------------|----------|
| | Number | Amount | paid-in | stock | deficit | comprehe |
| | ----- | ----- | capital | compensation | ----- | income (|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Balance as of January 1, 2004 | 5,410,680 | \$ 11,036 | \$ 1,437 | \$ - | \$ (9,445) | \$ |
| Issuance of Common shares, net | 716,179 | - | 743 | - | - | |
| Deferred stock compensation related to options granted to an employee | - | - | 25 | (25) | - | |
| Amortization of deferred stock compensation related to options granted to an employee | - | - | - | 10 | - | |
| Exercise of options | 10,000 | - | 7 | - | - | |
| Comprehensive loss: | | | | | | |
| Net loss | - | - | - | - | (733) | |
| Foreign currency translation | | | | | | |

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| | | | | | | |
|--|-----------|-----------|----------|---------|-------------|-------|
| adjustments | - | - | - | - | - | - |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total other comprehensive loss | | | | | | |
| Balance as of September 30, 2004 (unaudited) | 6,136,859 | \$ 11,036 | \$ 2,212 | \$ (15) | \$ (10,178) | \$ |
| | ===== | ===== | ===== | ===== | ===== | ===== |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Nine months ended September 30, | | |
|---|------------------------------------|----------|-----------|
| | 2004 | 2003 | 2002 |
| | | | Unaudited |
| | ----- | ----- | ----- |
| Cash flows from operating activities: | | | |
| Net loss | \$ (733) | \$ (574) | \$ |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Depreciation | 79 | 102 | |
| Loss on sale of property and equipment | 6 | - | |
| Compensation related to options granted to consultant and service providers | - | 758 | |
| Compensation related to options granted to an employee | 10 | - | |
| Decrease (increase) in deferred income taxes | - | (37) | |
| Decrease (increase) in trade receivables | (4) | 588 | |
| Decrease (increase) in prepaid expenses and other current assets | (65) | (182) | |
| Decrease (increase) in inventories | 168 | - | |
| Increase (decrease) in accounts payable | 224 | (457) | |
| Decrease in other current liabilities | (286) | (415) | |
| | ----- | ----- | ----- |
| Net cash used in operating activities | (601) | (217) | |
| | ----- | ----- | ----- |
| Cash flows from investing activities: | | | |

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| | | | |
|--|----------|----------|-------|
| Restricted short-term bank deposit | 65 | 600 | |
| Purchase of property and equipment | (22) | (62) | |
| Proceeds from sale of property and equipment | 3 | - | |
| Proceeds from long-term loan | - | 19 | |
| | ----- | ----- | ----- |
| Net cash provided by (used in) investing activities | 46 | 557 | |
| | ----- | ----- | ----- |
| Cash flows from financing activities: | | | |
| Proceeds from short-term bank credit | - | 40 | |
| Proceeds from issuance of Common shares | 743 | 600 | |
| Proceeds from long-term loan from a bank | - | 12 | |
| Payments made on short term bank credit | - | (290) | |
| Principal payments on capital lease obligations | - | (29) | |
| Exercise of options granted to an employee | 7 | - | |
| | ----- | ----- | ----- |
| Net cash provided by (used in) financing activities | 750 | 333 | |
| | ----- | ----- | ----- |
| Effect of exchange rate changes on cash and cash equivalents | 4 | 13 | |
| | ----- | ----- | ----- |
| Increase (decrease) in cash and cash equivalents | 199 | 686 | |
| Cash and cash equivalents at beginning of period | 1,050 | 616 | |
| | ----- | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 1,249 | \$ 1,302 | \$ |
| | ===== | ===== | ===== |
| Supplemental disclosure of cash flows activities: | | | |
| Cash paid during the period for interest | \$ - | \$ 8 | \$ |
| | ===== | ===== | ===== |

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

DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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 and sale of switching power supplies and converters. The Company has two reportable

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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, 2003, are applied consistently in these financial statements. In addition, the following accounting policy is applied:

The accompanying unaudited consolidated financial statements as of September 30, 2004 and for the nine months and three months ended September 30, 2004 and 2003 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, 2003. The results of operations for the nine months ended September 30, 2004 are not necessarily indicative of the results for the entire fiscal year ending December 31, 2004.

- b. Accounting for stock-based compensation:

The Company and its subsidiary have elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") in accounting for their employee stock option plans. Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

The Company and its subsidiary apply Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" ("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 issued to non-employees. SFAS No. 123 requires the use of an option valuation model to measure the fair value of the options at the date of grant.

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.)

Under SFAS No. 123, pro forma information regarding net loss and loss per share is required and has been determined as if the Company had

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accounted for its employee options under the fair value method of that statement. The fair value for these options was estimated at the date of grant using a Black-Scholes Option Valuation Model, with the following weighted-average assumptions for September 30, 2004 and 2003, expected volatility of 113% and 46%, respectively, risk-free interest rates of 4.7% and 1.5%, respectively, dividend yield of 0% for each period, and a weighted-average expected life of the option of 4 years for each period. Stock compensation, for pro-forma purposes, is amortized over the vesting period.

The following table illustrates the effect on net loss and loss per share as if the fair value method had been applied to all outstanding and unvested awards in each period:

| | Nine months ended September 30, | |
|--|------------------------------------|------------|
| | 2004 | 2003 |
| | Unaudited | |
| Net loss available to Ordinary shares - as reported | \$ (733) | \$ (6,000) |
| Deduct - stock-based employee compensation - intrinsic value | 10 | (10) |
| Add - stock-based employee compensation -fair value | (143) | (10) |
| | \$ (866) | \$ (6,110) |
| Pro forma net loss | \$ (866) | \$ (6,110) |
| Loss per share: | | |
| Basic and diluted net loss, as reported | \$ (0.13) | \$ (0.10) |
| | \$ (0.15) | \$ (0.10) |
| Pro forma basic and diluted net loss | \$ (0.15) | \$ (0.10) |

NOTE 3:- SHARE CAPITAL

- a. On January 12, 2004, the Company entered into an agreement to sell 290,023 shares of Common stock to Telkooor Telecom Ltd. ("Telkooor"), in consideration of \$ 246, net of issuance expenses.
- b. On June 16, 2004, the Company entered into an agreement to sell 221,238 shares of Common stock to Telkooor, in consideration of \$ 247, net of issuance expenses. Additionally, under the abovementioned agreement, Telkooor may purchase additional shares of Common stock for an aggregate consideration of \$ 250, prior to or on December 31, 2004, as determined in the agreement.
- c. On June 29, 2004, the Company entered into an agreement to sell 204,918 shares of Common stock to a new investor, in consideration of \$ 250, of which the closing took place in July 2004. Additionally, under the abovementioned agreement, the new investor may purchase additional shares of Common stock for an aggregate consideration of \$ 250, prior to or on December 31, 2004.

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NOTE 4:- LEGAL PROCEEDINGS

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. ("Tek-Tron") in the state court of Pennsylvania, specifically, the Court of Common Pleas of Bucks County, at Case No. 0302116-24-1. Tek-Tron was seeking damages of approximately \$ 300. This case is a complaint for breach of contract and conversion of parts and infrastructure owned by Tek-Tron located in the Company's former subsidiary, Poder Digital S.A.'s, Mexico manufacturing plant.

In April 2004, the Company signed a settlement agreement with Tek-Tron according to which the Company agreed to pay a total of \$90 in installments. As of September 2004, the Company paid the full \$90. Additionally, under the settlement agreement, Tek-Tron has the ability to seek arbitration limited to the sum of \$50 in case the parties do not agree on a resolution regarding the returned property. Tek-Tron has notified the Company it believes that the disputed property contains missing or damaged items. The Company continues to work on reaching a resolution over the returned property for which the Company has a maximum liability of \$50 under the settlement agreement. Company's management and its legal advisor are unable to assess the outcome of such arbitration proceeding.

NOTE 5:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHICAL 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:

| | Nine months ended September 30, | | |
|-------------------------|---------------------------------|----------|------|
| | DPC | DPL | Elim |
| Revenues | \$ 2,874 | \$ 3,284 | \$ |
| Intersegment revenues | 613 | - | |
| Total revenues | \$ 3,487 | \$ 3,284 | \$ |
| Depreciation expenses | \$ 23 | \$ 56 | \$ |
| Operating loss | \$ (452) | \$ (270) | \$ |
| Financial expenses, net | | | |
| Other expenses | | | |

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| | | | |
|--|----------|----------|----|
| Net loss | \$ (450) | \$ (283) | \$ |
| Expenditures for segment assets at September 30, 2004 | \$ 15 | \$ 7 | \$ |
| Identifiable assets at September 30, 2004 | \$ 2,040 | \$ 3,073 | \$ |

NOTE 5:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHICAL INFORMATION (Cont.)

| | Nine months ended September 30, | | |
|--|---------------------------------|----------|------|
| | DPC | DPL | Elim |
| Revenues | \$ 2,718 | \$ 2,620 | \$ |
| Intersegment revenues | 535 | - | |
| Total revenues | \$ 3,253 | \$ 2,620 | \$ |
| Depreciation expenses | \$ 25 | \$ 77 | \$ |
| Operating loss | \$ (441) | \$ (218) | \$ |
| Financial income, net | | | |
| Loss before tax benefit | | | |
| Tax benefit | \$ - | \$ 73 | \$ |
| Net loss | \$ (450) | \$ (124) | \$ |
| Expenditures for segment assets at September 30, 2003 | \$ 12 | \$ 50 | \$ |
| Identifiable assets at September 30, 2003 | \$ 1,956 | \$ 2,767 | \$ |

| | Three months ended September 30 | | |
|--|---------------------------------|-----|------|
| | DPC | DPL | Elim |

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| | ----- | ----- | ----- |
|--|----------|----------|-------|
| Revenues | \$ 1,019 | \$ 1,171 | \$ |
| Intersegment revenues | 196 | - | |
| | ----- | ----- | ----- |
| Total revenues | \$ 1,215 | \$ 1,171 | \$ |
| | ===== | ===== | ===== |
| Depreciation expenses | \$ 8 | \$ 21 | \$ |
| | ===== | ===== | ===== |
| Operating loss | \$ (93) | \$ (124) | \$ |
| | ===== | ===== | ===== |
| Financial expenses, net | | | |
| Other expenses | | | |
| Net loss | \$ (97) | \$ (133) | \$ |
| | ===== | ===== | ===== |
| Expenditures for segment assets at September 30, 2004 | \$ 7 | \$ 3 | \$ |
| | ===== | ===== | ===== |
| Identifiable assets at September 30, 2004 | \$ 2,040 | \$ 3,073 | \$ |
| | ===== | ===== | ===== |

NOTE 5: SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHICAL INFORMATION (Cont.)

| | Three months ended September 30 | | |
|-----------------------|---------------------------------|---------|-------|
| | DPC | DPL | Elim |
| | ----- | ----- | ----- |
| Revenues | \$ 855 | \$ 754 | \$ |
| Intersegment revenues | 125 | - | |
| | ----- | ----- | ----- |
| Total revenues | \$ 980 | \$ 754 | \$ |
| | ===== | ===== | ===== |
| Depreciation expenses | \$ 8 | \$ 23 | \$ |
| | ===== | ===== | ===== |
| Operating loss | \$ (176) | \$ (70) | \$ |
| | ===== | ===== | ===== |
| Financial income, net | | | |

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Loss before tax benefit

| | | | | | |
|--|----|-------|----|-------|----|
| Tax benefit | \$ | - | \$ | 47 | \$ |
| | | | | | |
| Net loss | \$ | (173) | \$ | (21) | \$ |
| | | | | | |
| Expenditures for segment assets for the three months ended September 30, 2003 | \$ | 2 | \$ | 18 | \$ |
| | | | | | |
| Identifiable assets at September 30, 2003 | \$ | 1,956 | \$ | 2,767 | \$ |
| | | | | | |

- - - - -

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 Mexico, China and other risks factors detailed in the Company's Form 10-KSB for the year ended December 31, 2003. Readers of this report are cautioned not to put undue reliance on "forward looking" statements which are, by their nature, uncertain as reliable indicators of future performance. 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 and selling switching power supplies to telecommunications, data communication, test and measurement equipment, office and factory automation and instrumentation equipment manufacturers. Revenues are generated from sales to distributors, OEMs in the telecommunication, data communication, test and measurements equipment, office and factory automation and instrumentation manufacturers' equipment in North America, Europe and the United Kingdom.

We have continued our efforts to increase sales to existing and new customers, and continue our strategy to manufacture our product in the Far East. Until revenues increase to a sufficient amount to offset our expenses, we anticipate that we will continue to experience net losses for the near future. We believe that our cash will be sufficient to fund those losses for the near future.

In July 2004, we raised \$250,000 through the sale of 204,918 shares of common stock at \$1.22 per share. We intend to use the additional financing as working

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capital to implement our business plan.

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004, COMPARED TO SEPTEMBER 30, 2003

REVENUES

For the three months ended September 30, 2004, revenues increased by 36.1% to \$2,190,000 from \$1,609,000 for the nine months ended September 30, 2003. Total revenues increased by 36.1% to \$2,190,000 for the three months ended September 30, 2004, from \$1,609,000 for the three months ended September 30, 2003.

Revenues from the domestic operations of DPC increased 19.2% to \$1,019,000 for the third quarter ended September 30, 2004, from \$855,000 for the third quarter ended September 30, 2003. Revenues from the Company's European operations of DPL increased 55.3% to \$1,171,000 for the third quarter ended September 30, 2004, from \$754,000 for the third quarter ended September 30, 2003. The revenue increase in the third quarter of 2004 is mainly due to increase in sales of our new products.

For the nine months ended September 30, 2004, revenues increased by 15.4% to \$6,158,000 from \$5,338,000 for the nine months ended September 30, 2003. Revenues attributed to the domestic operations of DPC increased 5.7% to \$2,874,000 for the nine months ended September 30, 2004, from \$2,718,000 for the nine months ended September 30, 2003. Revenues from the Company's European operations of DPL increased 25.3% to \$3,284,000 for the nine months ended September 30, 2004, from \$2,620,000 for the nine months ended September 30, 2003. The increase in revenue from the Company's European operations of DPL is mainly due to higher sales of our new products.

GROSS MARGINS

Gross margins were 23.8% for the three months ended September 30, 2004, compared to 26.7% for the three months ended September 30, 2003. The decrease in gross margins can be primarily attributed to the shift in product mix. Gross margins were 24.1% for the nine months ended September 30, 2004 compared to 27.3% for the nine months ended September 30, 2003. The decrease in gross margins can be primarily attributed to the shifting in product mix. The Company is working toward its plan to increase gross margins through reducing costs and promoting sales of higher margin products.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 7.2% of revenues for the three months ended September 30, 2004, and 6.9% for the three months ended September 30, 2003. In actual dollars, engineering and product development increased by \$46,000. Engineering and product development expenses were 7.3% of revenues for the nine months ended September 30, 2004, compared to 7.2% of revenues for the nine months ended September 30, 2003.

SELLING AND MARKETING

Selling and marketing expenses were 14.8% of revenues for the three months ended September 30, 2004, compared to 16.5% for the three months ended September 30, 2003. In absolute dollars, the selling and marketing expenditures increased by \$59,000 mainly due to increase in travel and advertising expenses as part of our efforts to increase sales in the future. Selling and marketing expenses were 15.4% of revenues for the nine months ended September 30, 2004, compared to 14.7% for the nine months ended September 30, 2003. The increase in selling and marketing were primarily due to new hires and increase in advertising and travel expenses.

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GENERAL AND ADMINISTRATIVE

General and administrative expenses were 11.7% of revenues for the three months ended September 30, 2004, compared to 18.6% for the three months ended September 30, 2003. In actual dollars, general and administrative expenditures decreased by \$43,000 mainly due to reduction in the personnel hours spent on administrative duties. General and administrative expenses were 13.2% of revenues for the nine months ended September 30, 2004, compared to 17.7% for the nine months ended September 30, 2003. In actual dollars, general and administrative expenses decreased by \$135,000.

FINANCIAL INCOME

Financial expense net was \$7,000 for the three months ended September 30, 2004, compared to financial income net of \$5,000 for the three months ended September 30, 2003. The financial expense resulted mainly from the exchange rate fluctuation. Financial expense was \$5,000 for the nine months ended September 30, 2004, compare to financial income of \$12,000 for the nine months ended September 30, 2003.

LOSS BEFORE INCOME TAXES

For the three months ended September 30, 2004, the Company had a loss before income taxes of \$230,000 compared to a loss before income taxes of \$241,000 for the three months ended September 2003. The loss decreased mainly due to the increase in revenues. Loss before income taxes for the nine months ended September 30, 2004 increased to \$733,000 compared to \$647,000 for the nine months ended September 30, 2003. The loss increased mainly due to the reduction in gross margins.

TAX BENEFIT

The tax benefit of \$47,000 for the third quarter of 2003 was from the Company's European operations of DPL.

NET LOSS

Net loss for the three months ended September 30, 2004, was \$230,000 compared to net loss of \$194,000 for the three months ended September 30, 2003. Net loss for the nine months ended September 30, 2004 was \$733,000, compared to a net loss of \$574,000 for the nine months ended September 30, 2003. Net loss increased mainly due to lower gross margins.

LIQUIDITY AND CAPITAL RESOURCES

On September 30, 2004, the Company had cash, cash equivalents \$1,249,000 and working capital of \$2,785,000. This compares with cash and cash equivalents of \$1,302,000 and working capital of \$2,956,000 at September 30, 2003. The decrease in working capital is mainly due to operating losses offset partially by the Telkoor Telecom Ltd.'s and Fortron/Source investments of \$743,000 after issuance expenses during the nine months ended September 30, 2004.

Cash used in operating activities for the Company totaled \$184,000 for the three months ended September 30, 2004, compared to \$45,000 for the three months ended September 30, 2003. Cash provided by investing activities was \$58,000 for the three months ended September 30, 2004, compared to cash used in investing activities of \$14,000 for the three months ended September 30, 2003. Net cash provided by financing activities was \$250,000 for the three months ended September 30, 2004, compared to net cash used by financing activities of \$2,000 for the three months ended September 30, 2003.

The Company has an available line of credit with Silicon Valley Bank ("SVB"). The Company can borrow up to \$1,200,000 against eligible accounts receivable and other financial covenants. The rate for this line of credit would be at Silicon Valley Bank's prime rate plus 1.75%. In order to utilize the line of credit, the Company is required to maintain certain ratios and be in compliance with other covenants. As of September, 2004, the Company has not utilized its line of

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credit.

The Company's subsidiary has a \$271,000 line of credit with Lloyds TSB Bank. Borrowing under this line of credit bears interest of 1.75% per annum over the bank's base rate. The Company's subsidiary has not utilized its line of credit.

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.

ITEM 3. CONTROLS AND PROCEDURES

The Company's management with the participation of the Company's principal executive and financial officers evaluated the effectiveness of the Company's disclosure controls and procedures (as defined Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this report. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Based upon their evaluation, the Company's principal executive and financial officers concluded that the Company's disclosure controls and procedures are effective to accumulate and communicate to the Company's management as appropriate to allow timely decisions regarding disclosure.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. in the state court of Pennsylvania, specifically, the Court of Common Pleas of Bucks County, as Case No. 0302116-24-1. Tek-Tron Enterprises, Inc is seeking damages of approximately \$300,000. This case is a complaint for breaking of contract and conversion of parts and infrastructure owned by Tek-Tron Enterprises, Inc. located in the Company's former subsidiary, Poder Digital S.A's, Mexico manufacturing plant.

In April 2004, the Company signed a settlement agreement with Tek-Tron according to which the Company agreed to pay a total of \$90,000 in installments. As of September 2004, the Company paid the full \$90,000. Additionally, under the settlement agreement, Tek-Tron has the ability to seek arbitration limited to the sum of \$50,000 in case the parties do not agree on a resolution regarding the returned property. Tek-Tron has notified the Company it believes that the disputed property contains missing or damaged items. The Company continues to work on reaching a resolution over the returned property for which the Company has a maximum liability of \$50,000 under the settlement agreement.

ITEM 2. CHANGES IN SECURITIES

As previously reported, during the third quarter, on July 8, 2004, the Company sold 204,918 shares of common stock at \$1.22 per share to Fortron/Source Corp. Under the terms of the securities purchase agreement, Fortron/Source Corp. may invest an additional \$250,000 each on or before December 31, 2004. The purchase price per share for the additional investment is the average closing price of the Company's common stock twenty (20) trading days prior to entering into the securities purchase agreement. There was no broker or placement agent in this transaction.

The sales and issuance of common stock was made by us in reliance upon the exemptions from registration provided under Section 4(2) and 4(6) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D, promulgated by

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the SEC under federal securities laws and comparable exemptions for sales to an "accredited" investor under state securities laws. The offers and sales were made to an accredited investor as defined in Rule 501(a) under the Securities Act, no general solicitation was made by us or any person acting on our behalf; the securities sold were subject to transfer restrictions, and the certificate for those shares contained an appropriate legend stating that the shares had not been registered under the Securities Act and may not be offered or sold absent registration or pursuant to an exemption there from.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

The annual meeting of the shareholders was held on Thursday, October 7, 2004 at the Company's corporate headquarters, located at 41920 Christy Street, Fremont, California 94538. The shareholders voted to elect the following persons as Directors of the Company:

| Nominees | Shares Voted For | Shares Withholding Authority/Voted Against |
|-------------------|------------------|--|
| Ben- Zion Diamont | 5,802,430 | 77,913 |
| David Amitai | 5,804,430 | 75,913 |
| Amos Kohn | 5,810,930 | 69,413 |
| Yeheskel Manea | 5,802,030 | 78,313 |
| Youval Menipaz | 5,802,030 | 78,313 |

The Shareholders approved an amendment to increase the number of shares available for grant under the 2002 Stock Option Plan by 300,000 shares.

| Total shares voted: | For | Against | Withheld | Abs Broker Non- |
|---------------------|-----------|---------|----------|--------------------|
| | 3,713,047 | 150,927 | 3,805 | 0 |

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits

31.1 Certification of the CEO under the Sarbanes-Oxley Act

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31.2 Certification of the CFO under the Sarbanes-Oxley Act
32 Certification of the CEO & CFO under the Sarbanes-Oxley Act

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: November 15, 2004

/s/ Jonathan Wax

Jonathan Wax
Chief Executive Officer
(Principal Executive Officer)

Date: November 15, 2004

/s/ Uzi Sasson

Uzi Sasson
Chief Financial Officer
(Principal Financial Officer)