DIGITAL POWER CORP
Form 10QSB
May 16, 2005

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

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended March 31, 2005

[ ] 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 incorporation or organization)	(IRS Employer Identification No.)

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

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

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

Number of shares of common stock outstanding as of May 6, 2005: 6,161,859

DIGITAL POWER CORPORATION

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

AS OF MARCH 31, 2005

IN U.S. DOLLARS

UNAUDITED

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[ERNST & YOUNG LOGO OMITTED]

The Board of Directors
Digital Power Corporation

Re: Review report of unaudited interim consolidated financial statements as of and for the three-month period ended March 31, 2005

We have reviewed the accompanying consolidated balance sheet of Digital Power Corporation ("the Company") and its subsidiary as of March 31, 2005, and the related consolidated statements of operations, and cash flows for the three-month periods ended March 31, 2005 and 2004 and changes in shareholders' equity for the three-month period ended March 31, 2005 in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the Company's management.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

/s/ Kost Forer Gabbay & Kasierer

Tel-Aviv, Israel
May 13, 2005

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

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DIGITAL POWER CORPORATION

CONSOLIDATED BALANCE SHEET

U.S. dollars in thousands

ASSETS

CURRENT ASSETS:
Cash and cash equivalents

Restricted cash
Trade receivables, net of allowance for doubtful accounts of $111 at March 31, 2005
Prepaid expenses and other current assets
Inventories

Total current assets

LEASE DEPOSITS

PROPERTY AND EQUIPMENT, NET

Total assets

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

CONSOLIDATED BALANCE SHEET

U.S. dollars in thousands, except share data

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:
Accounts payable
Related party - trade payables account
Other current liabilities
Convertible loan (note 4)

Total current liabilities

SHAREHOLDERS' EQUITY:
Series A redeemable, convertible preferred shares no par value: 500,000 shares authorized, 0 s
issued and outstanding at March 31, 2005

Preferred shares, no par value: 1,500,000 shares authorized, 0 shares issued and outstanding a
March 31, 2005
Common shares, no par value: 10,000,000 shares authorized; 6,161,859 shares issued and outstan
at March 31, 2005
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

	Th
	2005
Revenues	$ 1
Cost of revenues	1
Gross profit	
Operating expenses:	
Engineering and product development	
Selling and marketing	

General and administrative	
Total operating expenses	
Operating loss	
Financial income (expenses), net	
Net loss	$
Basic and diluted loss per share	$ (
Weighted average number of shares used in computing basic and diluted loss per share	6,161

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 SHARE DATA

	Common shares		Additional paid-in	Deferred stock	Accumulated	Accu o comp
	Number	Amount	capital	compensation	deficit	
Balance as of January 1, 2005	6,161,859	$ 11,036	$ 2,227	$ (13)	$ (10,620)	$
Amortization of deferred stock compensation related to options granted to an employee	-	-	-	2	-	
Comprehensive loss:						
Net loss	-	-	-	-	(183)	
Foreign currency translation adjustments	-	-	-	-	-	

Total comprehensive loss						
Balance as of March 31, 2005 (Unaudited)	6,161,859	$ 11,036	$ 2,227	$ (11)	$ (10,803)	$

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

	Th
	2005
Cash flows from operating activities:	
Net loss	$ (18
Adjustments required to reconcile net loss to net cash used in operating activities:	
Depreciation	2
Compensation related to options granted to an employee	
Decrease in trade receivables	19
Decrease (increase) in prepaid expenses and other current assets	8
Decrease (increase) in inventories	(36
Decrease in accounts payable and related parties	(21
Increase (decrease) in other current liabilities	(12
Net cash used in operating activities	(59
Cash flows from investing activities:	
Purchase of property and equipment	(
Net cash used in investing activities	(
Cash flows from financing activities:	
Restricted cash	(

Proceeds from a convertible loan	25
Proceeds from issuance of Common shares, net	
Net cash provided by financing activities	24
Effect of exchange rate changes on cash and cash equivalents	(
Increase (decrease) in cash and cash equivalents	(36
Cash and cash equivalents at the beginning of the period	1,37
Cash and cash equivalents at the end of the period	$ 1,01

The accompanying notes are an integral part of the 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 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, 2004, are applied consistently in these financial statements. In addition the following accounting policy is applied:

The accompanying unaudited consolidated financial statements as of March 31, 2005 and for the three months ended March 31, 2005 and 2004 are unaudiated 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, 2004. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results for the entire fiscal year ending December 31, 2005.

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 its 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 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

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Services" ("EITF 96-18"), with respect to options issued to non-employees SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

Under Statement of Financial Accounting Standard No. 123 "Accounting for Stock Based compensation ("SFAS No. 123") SFAS No. 123, proforma information regarding net earnings (loss) and net earnings (loss) per share is required and has been determined as if the Company had 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 March 31, 2005 and 2004, expected volatility of 103% and 113%, respectively, risk-free interest rates of 4% and 4.7%, respectively, dividend yield of 0% for each period, and a weighted-average expected life of the option of 7 years and 4 years for March 31, 2005 and 2004, respectively. 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:

	2
Net loss available to Common shares - as reported	$
Deduct - stock-based employee compensation - intrinsic value	
Add - stock-based employee compensation -fair value	
Pro forma net loss	$
Loss per share:	
Basic and diluted net loss, as reported	$
Pro forma basic and diluted net loss	$

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U.S. dollars in thousands

NOTE 3:- INVENTORIES

Raw materials, parts and supplies
Work in progress
Finished products

NOTE 4:- CONVERTIBLE LOAN

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

NOTE 5:- PENDING LITIGATION

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. ("Tek-Tron"). In April 2004, the Company signed a settlement agreement with Tek-Tron according to which the Company paid $ 90 and returned certain disputed inventory for a full release. The settlement agreement allowed Tek-Tron to seek arbitration limited to the sum of $ 50 in case the parties do not agree on a resolution regarding the returned inventory. Tek-Tron initiated arbitration against the Company for $ 50 plus attorney fees. The arbitration hearing was held on May 2, 2005, and Tek-Tron was awarded $ 5 in damages and no attorney fees.

NOTE 6:- 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").

U.S. dollars in thousands

NOTE 6:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHICAL INFORMATION

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

	Three months ended March 31, 200		
	DPC	DPL	Elimi
Revenues	$ 970	$ 965	$
Intersegment revenues	74	-	
Total revenues	$ 1,044	$ 965	$
Depreciation expense	$ 5	$ 17	$
Operating loss	$ (24)	$ (148)	$
Financial expenses, net			
Net loss	$ (21)	$ (162)	$
Expenditures for segment assets as of March 31, 2005	$ (4)	$ -	$
Identifiable assets as of March 31, 2005	$ 1,873	$ 2,968	$

U.S. dollars in thousands

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

	Three months ended March 31, 200		
	DPC	DPL	Elimin
Revenues	$ 784	$ 1,045	$
Intersegment revenues	138	-	
Total revenues	$ 922	$ 1,045	$
Depreciation expense	$ 7	$ 18	$
Operating loss	$ (233)	$ (51)	$
Financial income, net			
Net loss	$ (237)	$ (15)	$
Expenditures for segment assets as of March 31, 2004	$ -	$ 4	$
Identifiable assets as of March 31, 2004	$ 2,242	$ 2,972	$

NOTE 7:- SUBSEQUENT EVENTS

On May 3, 2005, the Company received a written notice from the American Stock Exchange ("the AMEX"), advising that the Company was not in compliance with the Amex's listing requirements. In order to maintain its AMEX listing, the Company must submit a recovery plan, advising of the actions it takes to bring the Company into compliance with the continued listing standards within a maximum of 18 months. If the plan is accepted, the Company will be able to continue its listing during the plan period, subject to AMEX's periodic reviews. If the Company is not in compliance with the listing standards at the end of such 18 months period or fails the periodic reviews, the AMEX will initiate delisting proceedings. The Company is planning to submit a plan in accordance with the AMEX requirements.

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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, 2004. 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 the industrial, telecommunication, data communication, medical and military industries. Revenues are generated from sales to distributors, OEMs in North America, Europe and the United Kingdom.

We have continued our efforts to increase sales to existing and new customers, and continue our strategy to manufacture our products 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.

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

THREE MONTHS ENDED MARCH 31, 2005, COMPARED TO MARCH 31, 2004

REVENUES
Total revenues increased by 5.8% to $1,935,000 for the first quarter ended March 31, 2005, from $1,829,000 for the first quarter ended March 31, 2004. The increase in revenue is mainly due to our newer products developed through Telkoor being received well in the market place.

Revenues from the domestic operation of DPC increased by 23.7% to $970,000 for the first quarter ended March 31, 2005, from $784,000 for the first quarter ended March 31, 2004. Revenues from the Company's European operations of DPL decreased 7.7% to $965,000 for the first quarter ended March 31, 2005, from $1,045,000 for the first quarter ended March 31, 2004.

GROSS MARGINS
Gross margins were 31.5% for the three months ended March 31, 2005, compared to 23.8% for the three months ended March 31, 2004. The increase in gross margins can be partially attributed to the increase use of contract manufacturers in the Far East, and the use of previously written off inventory at the subcontract manufacturer located in Mexico.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 6.5% of revenues for the three months ended March 31, 2005, and 7.5 % for the three months ended March 31, 2004. Actual dollar expenditures decreased by $12,000.

SELLING AND MARKETING
Selling and marketing expenses were 18.3% of revenues for the three months ended March 31, 2005, compared to 16.6% for the three months ended March 31, 2004. The increase in selling and marketing was primarily due to new hires, and travel expenses as part of our efforts to increase sales.

GENERAL AND ADMINISTRATIVE
General and administrative expenses were 15.6% of revenues for the three months ended March 31, 2005 compared to 15.3% for the three months ended March 31, 2004.

FINANCIAL INCOME (EXPENSES)
Net financial expenses was $11,000 for the three months ended March 31, 2005, compared to net financial income of $32,000 for the three months ended March 31, 2004. The financial expense resulted mainly from exchange rate fluctuation.

NET LOSS
Net loss for the three months ended March 31, 2005, was $183,000 compared to net loss of $252,000 for the three months ended March 31, 2004. The net loss decrease is mainly due to the increase in revenues and gross margin.

LIQUIDITY AND CAPITAL RESOURCES
On March 31, 2005, the Company had cash, cash equivalent and a short-term bank deposit of $1,011,000 and working capital of $2,251,000. This compares with cash and cash equivalent of $1,164,000 and working capital of $2,727,000 at March 31, 2004. The decrease in working capital is mainly due to decrease in cash and increase in accounts payable and related party payable, offset partially by decrease in other current liabilities.

Cash used in operating activities for the Company totaled $593,000 for the three months ended March 31, 2005, compared to cash used of $134,000 for the three months ended March 31, 2004. The increase of cash used in operating activities is mainly due to the loss from operating activities, increase in inventory, and decrease in accounts payable. Cash used in investing activities was $4,000 for the three months ended March 31, 2005 and for the three months ended March 31, 2004. Net cash provided by financing activities was $243,000 for the three months ended March 31, 2005, compared to the net cash provided of $246,000 for the three months ended March 31, 2004.

The Company has available a 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 March 31, 2005, the Company has not utilized its line of credit.

AMEX LISTING
On May 3, 2005, the Company received a written notice from the American Stock Exchange ("the AMEX"), advising that the Company was not in compliance with the Amex's listing requirements. In order to maintain its AMEX listing, the Company must submit a recovery plan, advising of the actions it takes to bring the Company into compliance with the continued listing standards within a maximum of 18 months. If the plan is accepted, the Company will be able to continue its

listing during the plan period, subject to AMEX's periodic reviews. If the Company is not in compliance with the listing standards at the end of such 18 months period or fails the periodic reviews, the AMEX will initiate delisting proceedings. The Company is planning to submit a plan in accordance with the AMEX requirements.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On April 2, 2003, a claim was filed against the Company by Tek-Tron Enterprises Inc. ("Tek-Tron") in state court of Pennsylvania, specifically, the court of Common Pleas of Bucks County, at Case No. 0302116241. In April 2004, the Company signed a settlement agreement with Tek-Tron according to which the Company paid $90,000 and return certain disputed inventory for a full release. The settlement agreement allowed Tek-Tron to seek arbitration limited to the sum of $50,000 in case the parties do not agree on a resolution regarding the returned inventory. Tek-Tron initiated arbitration against the Company for $50,000 plus attorney fees. The arbitration hearing was held on May 2, 2005, and Tek-Tron was awarded $5,000 in damages and no attorney fees.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits

31.1 Certification of the CEO under the Sarbanes-Oxley Act

31.2 Certification of the CFO under the Sarbanes-Oxley Act

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SIGNATURES

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

DIGITAL POWER CORPORATION
(Registrant)

/s/ Jonathan Wax

Date: May 16, 2005

Jonathan Wax,
Chief Executive Officer
(Principal Executive Officer)

/s/ Leo Yen

Date: May 14, 2005

Leo Yen,
Chief Financial Officer
(Principal Financial Officer)