

DIGITAL POWER CORP  
Form 10-Q  
May 14, 2009

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U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2009

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission file number 1-12711

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DIGITAL POWER CORPORATION  
(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

94-1721931  
(I.R.S. Employer Identification Number)

41324 Christy Street  
Fremont, CA 94538-3158  
(Address of principal executive offices)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12(b)-2 of the Exchange Act). Yes  No

At May 6, 2009, the registrant had outstanding 6,615,708 shares of common stock.

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## DIGITAL POWER CORPORATION

## TABLE OF CONTENTS

	Page
<b>PART I – FINANCIAL INFORMATION</b>	<b>3</b>
Item 1. Financial Statements	3
Consolidated Balance Sheets as of March 31, 2009 and December 31, 2008	3
Consolidated Statements of Operations for the three months ended March 31, 2009 and March 31, 2008	4
Statement of Changes in Shareholders' Equity for the three months ended March 31, 2009	5
Consolidated Statements of Cash Flows for the three months ended March 31, 2009 and December 31, 2008	6
Notes to Consolidated Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	12
Item 3. Quantitative and Qualitative Disclosures About Market Risk	15
Item 4T. Controls and Procedures	15
<b>PART II – OTHER INFORMATION</b>	<b>15</b>
Item 1. Legal Proceedings	15
Item 1A. Risk Factors	15
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	20
Item 3. Defaults Upon Senior Securities	20
Item 4. Submission of Matters to a Vote of Security Holders	20
Item 5. Other Information	21
Item 6. Exhibits	21
<b>SIGNATURES</b>	<b>21</b>

## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## CONSOLIDATED BALANCE SHEETS

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

	March 31, 2009 Unaudited	December 31, 2008
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 1,753	\$ 2,476
Restricted cash	75	76
Trade receivables, net of allowance for doubtful accounts of \$ 123 and \$ 124 as of March 31, 2009 and December 31, 2008, respectively	1,922	1,901
Prepaid expenses and other accounts receivable	234	139
Inventories	1,513	1,494
Total current assets	5,497	6,086
PROPERTY AND EQUIPMENT, NET	143	153
LONG-TERM DEPOSITS	41	41
Total assets	\$ 5,681	\$ 6,280
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 746	\$ 1,069
Related parties – trade payables	476	957
Deferred revenues	161	134
Other current liabilities	520	514
Total current liabilities	1,903	2,674
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital -		
Series A redeemable, convertible preferred shares, no par value - 500,000 shares authorized, 0 shares issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Preferred shares, no par value - 1,500,000 shares authorized, 0 shares issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Common shares, no par value - 30,000,000 shares authorized; 6,615,708 shares issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Additional paid-in capital	13,951	13,927
Accumulated deficit	(9,615)	(9,784)

Accumulated other comprehensive loss	(558)	(537)
Total shareholders' equity	3,778	3,606
Total liabilities and shareholders' equity	\$ 5,681	\$ 6,280

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

- 3 -

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**CONSOLIDATED STATEMENTS OF OPERATIONS**


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

	Three months ended March 31, 2009                  2008 Unaudited	
Revenues	\$ 2,421	\$ 3,169
Cost of revenues	1,490	2,345
Gross profit	931	824
Operating expenses:		
Engineering and product development	136	160
Selling and marketing	319	270
General and administrative	334	559
Total operating expenses	789	989
Operating income (loss)	142	(165)
Financial income, net	27	4
Net income (loss)	\$ 169	\$ (161)
Basic and diluted net earnings per share	\$ 0.025	\$ (0.024)

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

## STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Common shares		Additional	Accumulated	Other	Total	Total
	Number	Amount	paid-in	deficit	accumulated	comprehensive	shareholders'
			capital		loss	income	equity
Balance as of January 1, 2009	6,615,708	\$ -	\$ 13,927	\$ (9,784)	\$ (537)		\$ 3,606
Stock compensation related to options granted to Telkoor's employees and other non-employee consultant	-	-	7	-	-		7
Stock compensation related to options granted to employees	-	-	17	-	-		17
Comprehensive income:							
Net income	-	-	-	169	-	\$ 169	169
Foreign currency translation adjustments	-	-	-	-	(21)	(21)	(21)
Total comprehensive loss						\$ 148	
Balance as of March 31, 2009 (unaudited)	6,615,708	\$ -	\$ 13,951	\$ (9,615)	\$ (558)		\$ 3,778

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Three months ended March 31, 2009                  2008 Unaudited	
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$     169	\$    (161)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	26	25
Stock compensation related to options granted to employees	17	21
Stock compensation related to options granted to Telkoor's employees	7	12
Decrease (increase) in trade receivables, net	(40)	143
Increase in prepaid expenses and other accounts receivable	(97)	(46)
Decrease (increase) in inventories	(40)	12
Decrease in accounts payable and related parties- trade payables	(809)	(273)
Increase in deferred revenues and other current liabilities	40	319
Net cash provided by (used in) operating activities	(727)	52
<b>Cash flows from investing activities:</b>		
Proceeds from (purchase of) property and equipment	(17)	18
Net cash provided by (used in) investing activities	(17)	18
Effect of exchange rate changes on cash and cash equivalents	21	3
Increase (decrease) in cash and cash equivalents	(723)	73
Cash and cash equivalents at the beginning of the period	2,476	1,443
Cash and cash equivalents at the end of the period	\$    1,753	\$    1,516

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, except share and per share data

NOTE 1:- GENERAL

Digital Power Corporation ("the Company" or "DPC") was incorporated in 1969, under the General Corporation Law of the State of California. The Company has a wholly-owned subsidiary, Digital Power Limited ("DPL"), located in the United Kingdom. The Company and its subsidiary are currently engaged in the design, manufacture, sale and distribution of switching power supplies and converters. The Company has two reportable geographic segments - North America (sales through DPC) and Europe (sales through DPL).

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. The significant accounting policies applied in the annual financial statements of the Company as of December 31, 2008, 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, 2009, and for the three months ended March 31, 2009 and 2008 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-K for the fiscal year ended December 31, 2008. The results of operations for the three months ended March 31, 2009, are not necessarily indicative of the results for the entire fiscal year ending December 31, 2009.

b. Accounting for stock-based compensation:

The Company has several stock-based employee compensation plans, which are described more fully in Note 4. The Company accounts for stock based compensation in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)").

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:-

## INVENTORIES

	March 31, 2009 Unaudited	December 31, 2008
Raw materials, parts and supplies	\$ 253	\$ 228
Work in progress	278	308
Finished products	982	958
	\$ 1,513	\$ 1,494

NOTE 4:-

## ACCOUNTING FOR STOCK BASED COMPENSATION

a. Stock option plans:

- Under the Company's stock option plans, options may be granted to employees, officers, consultants, service providers and directors of the Company or its subsidiary.
- As of March 31, 2009, the Company has authorized, by several Incentive Share Option Plans, the grant of options to officers, management, other key employees and others of up to 2,272,000 shares of the Company's common stock. As of March 31, 2009, options to purchase up to an aggregate of 745,870 shares of the Company's common stock are still available for future grant.
- The options granted generally become fully exercisable after four years and expire no later than 10 years from the approval date of the option plan under the terms of grant. Any options that are forfeited or cancelled before expiration become available for future grants.

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

	Three months ended March 31, 2009			
	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value *)
Outstanding at the beginning of the period	779,035	\$ 1.02		
Granted	20,000	\$ 0.93		
Forfeited	(20,000)	\$ 1.47		
Expired	-			
Outstanding at the end of the period	779,035	\$ 1.01	5.40	\$ 91

Exercisable options at the end of the period	606,535	\$	1.02	4.39	\$	73
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\*)Calculation of aggregate intrinsic value is based on the share price of the Company's common stock as of March 31, 2009 (\$ 0.97 per share).

- 8 -

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

The weighted-average grant-date fair value of options granted during the first three months of 2009, was \$ 0.93 per share.

As of March 31, 2009, there was \$ 144 of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the stock option plans. That cost is expected to be recognized over a period of two years.

## b. Employee Stock Ownership Plan:

The Company has an Employee Stock Ownership Plan ("ESOP") covering eligible employees. The ESOP provides for the Employee Stock Ownership Trust ("ESOT") to distribute shares of the Company's Common shares as retirement benefits to the participants. The Company has not distributed shares since 1998. As of March 31, 2009, the ESOT held 167,504 shares of Common stock.

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

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

1.	Numerator:	
	Three months ended	
	March 31,	
	2009	2008
	Unaudited	
Net income (loss) available to common shareholders	\$ 169	\$ (161)
2.	Denominator:	
Denominator for basic net earnings per share of weighted average number of common stock	6,615,708	6,615,708
Effect of dilutive securities:		
Employee stock options	75,173	-

Denominator for diluted net earnings per share of Common stock	6,690,881	6,615,708
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- 9 -

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

## NOTE 6:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

The Company has two reportable geographic segments, see Note 1 for a brief description of the Company's business.

The following data presents the revenues, expenditures and other operating data of the Company's geographic operating segments in accordance with Statement of Financial Accounting Standard No.131, "Disclosure About Segments of an Enterprise and Related Information" ("SFAS No. 131").

	Three months ended March 31, 2009 (unaudited)			
	DPC	DPL	Eliminations	Total
Revenues	\$ 1,108	\$ 1,313	\$ -	\$ 2,421
Intersegment revenues	82	7	(89)	-
Total revenues	\$ 1,190	\$ 1,320	\$ (89)	\$ 2,421
Depreciation expense	\$ 8	\$ 18	\$ -	\$ 26
Operating income (loss)	\$ (36)	\$ 178	\$ -	\$ 142
Financial income, net				27
Net income (loss)	\$ (29)	\$ 198	\$ -	\$ 169
Expenditures for segment assets, net as of March 31, 2009	\$ 7	\$ 10	\$ -	\$ 17
Identifiable assets as of March 31, 2009	\$ 2,606	\$ 3,075	\$ -	\$ 5,681

- 10 -

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

	Three months ended March 31, 2008 (unaudited)			
	DPC	DPL	Eliminations	Total
Revenues	\$ 1,149	\$ 2,020	\$ -	\$ 3,169
Intersegment revenues	29	-	(29)	-
Total revenues	\$ 1,178	\$ 2,020	\$ (29)	\$ 3,169
Depreciation expense	\$ 8	\$ 17	\$ -	\$ 25
Operating income (loss)	\$ (243)	\$ 78	\$ -	\$ (165)
Financial income, net				4
Net income (loss)	\$ (236)	\$ 75	\$ -	\$ (161)
Expenditures for segment assets, net as of March 31, 2008	\$ -	\$ 8	\$ -	\$ 8
Identifiable assets as of March 31, 2008	\$ 2,413	\$ 3,807	\$ -	\$ 6,220

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## ITEM 2.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on our expectations, beliefs, forecasts, intentions and future strategies and are signified by the words "expects," "anticipates," "intends," "believes" or similar language. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, and other characterizations of future events or circumstances are forward-looking statements. These forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under "Part II, Item 1A. Risk Factors" and elsewhere in this report. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. All forward-looking statements included in this quarterly report are based on information available to us on the date of this report and speak only as of the date hereof. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

In this quarterly report, the "Company," "we," "us" and "our" refer to Digital Power Corporation, a California corporation, and our wholly-owned subsidiary, Digital Power Limited.

### GENERAL

We are a solution-driven organization that designs, develops, manufactures and sells cutting-edge high-grade power system solutions to military/defense, telecom/datacom, industrial and medical industries. We are highly focused on custom product designs for both the commercial and military/defense markets, where customers demand high density, high efficiency and ruggedized products to meet the harshest operating conditions. We are a California corporation originally formed in 1969, and our common stock trades on the NYSE Amex under the symbol "DPW". Our corporate headquarters is located in the heart of the Silicon Valley.

We also have a wholly-owned subsidiary, Digital Power Limited ("DPL"), which operates under the brand name of "Gresham Power Electronics" ("Gresham"). Gresham is located in Salisbury, England, and designs, manufactures, sells and distributes power products and system solutions for the European marketplace, including power conversion products for naval and military applications and DC/AC inverters for the telecommunications industry

We believe that we are one of the first companies in the power systems solutions industry to introduce a product strategy based on the premise that products developed with an extremely flexible architecture enable rapid modifications to meet unique customer requirements for non-standard output voltages. The development and implementation of this strategy has resulted in broad acceptance in both the telecom/industrial and medical market segments for our new line of high density and high efficiency power products. These products set an industry standard for providing high power output in package sizes that are smaller than any other commercially available product.

We market and sell our products to many diverse market segments including the telecom, industrial, medical and military/defense industries. Our products serve a global market, with an emphasis on North America and Europe. We have an extremely broad product offering including Custom and Modified-Standard, Open-Frame, CompactPCI, ATSC Front-Ends and Power Over Ethernet (PoE), providing power output from 50 watts to 25,000 watts.



In an effort to provide short lead-times, high quality products and competitive prices to support our markets, we have entered into production agreements with numerous manufacturers located in Asia. These contract manufacturing (CM) agreements allow us to control production costs and insure high quality products deliverable in a timely matter to meet market demand.

- 12 -

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We intend to remain an innovative leader in the development of cutting-edge custom power solutions, rugged power systems to meet harsh and extreme environmental requirements, and high performance, high density and modular power systems. We are focusing today on developing even more high-grade custom power system solutions to numerous customers in a broadly diversified range of markets and challenging environments. Each product development is based on best of class performance criteria, including unique, advanced feature sets and a special layout to meet each of our customers' unique operating conditions where efficiency, size and time to market are key to their success. We intend to release these efforts to production within the next two to three quarters. Further, we believe that all of these new designs will have a near-term demand, as each of them is a full custom solution for industry leaders. Our customers' requirements for these new designs are similarly advanced and challenging, as they will serve as the foundation for leading edge products for mobile, medical, telecom and defense industries. Examples of current custom design projects include a medical mobile oxygen concentrator to provide unparalleled freedom for the active oxygen user, next generation digital video encoder systems and an optical fiber network distribution system. More recently, we have been awarded a contract to develop and manufacture a custom, advanced power solution for a leading provider of video delivery solutions to broadcast, cable, satellite, IPTV and mobile service providers worldwide. Digital Power will provide this product for the customer's next generation, scalable, content ingest platform for storage and streaming solutions for video-on-demand and high-speed data network architectures. We are also exploring innovative "green power" solutions that will complement our current product lines.

## RESULTS OF OPERATIONS

### THREE MONTHS ENDED MARCH 31, 2009, COMPARED TO MARCH 31, 2008

Our financial results for the first quarter of 2009 reflected the significance of our decision to focus on developing high-grade custom power solutions while continuing our cost reduction efforts. The resulting improvement in our gross margins (an increase to 38.5% for the three months ended March 31, 2009, compared to 26.0% for the comparable period in 2008) resulted in a respectable net income for the first quarter in spite of the revenue shortfall caused by the global recession.

#### Revenues

Total revenues decreased by 23.6% to \$2,421,000 for the three months ended March 31, 2009, from \$3,169,000 for the three months ended March 31, 2008. The decrease in revenues is mainly due to a decline in sales of our standard commercial products as a result of the global recession, partially offset by an increase in sales of our military products. Revenue from our military products increased by 16.0% to \$784,000 for the three months ended March 31, 2009, from \$676,000 for the three months ended March 31, 2008. Revenue from our commercial products decreased by 34.3% to \$1,637,000 for the three months ended March 31, 2009, from \$2,493,000 for the three months ended March 31, 2008. The increase in military product revenues was primarily due to scheduling and lead-time requirements of customer orders. As set forth above, the decrease in commercial product revenue resulted primarily from the broad-based global economic downturn.

Revenues from our U.S. operations decreased by 3.5% to \$1,108,000 for the three months ended March 31, 2009, from \$1,149,000 for the three months ended March 31, 2008. Revenues from our European operations of DPL decreased by 35.1% to \$1,313,000 for the three months ended March 31, 2009, from \$2,020,000 for the three months ended March 31, 2008. The decreases in our revenues from our U.S. and European operations are mainly attributed to a decrease in sales of our standard commercial products, partially offset by an increase in our military sales as discussed above. To lessen any potential impact of the ongoing global economic downturn, we have implemented a new strategy to extend our distribution network to cover numerous new market segments, such as alternative energy. In addition, we are continuing to expand our focus on full custom power solutions, which enable us to collaborate more closely with our customers and therefore anticipate the timing of design cycles, shipments and other customer requirements.

## Gross Margins

Gross margins increased to 38.5% for the three months ended March 31, 2009, compared to 26.0% for the three months ended March 31, 2008. The higher gross margins in 2009 were primarily attributable to the continued outsourcing of our production to contract manufacturers in Asia, cost reductions and variations in our product mix from quarter to quarter. We believe that another significant factor in the substantial increase in gross margins was our strategic shift, which began in 2008, away from a dependence upon commoditized products to more integrated custom product solutions. This value-added platform of solutions, where we work in concert with our strategic customers and their partners, requires a more direct, consultative selling effort on our part. We believe that some of this business may be of a seasonal nature, however, and that it most likely will not signify similar increases in gross margin in the future.

- 13 -

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### Engineering and Product Development

Engineering and product development expenses were \$136,000, or 5.6% of revenues, for the three months ended March 31, 2009, compared to \$160,000, or 5.1% of revenues, for the three months ended March 31, 2008. The decrease was primarily due to lower consulting expenses as well as to our adoption of a modified product development cost structure for several of our custom power system solution customers. This cost structure provides for a payment schedule from the customer that will in turn fund our development costs for that customer's project.

### Selling and Marketing

Selling and marketing expenses were \$319,000, or 13.2% of revenues, for the three months ended March 31, 2009, compared to \$270,000, or 8.5% of revenues, for the three months ended March 31, 2008. Actual dollar expenditures increased by \$49,000 in 2009, mainly due to an increase in travel and advertising.

### General and Administrative

General and administrative expenses were \$334,000, or 13.8% of revenues, for the three months ended March 31, 2009, compared to \$559,000, or 17.6% of revenues, for the three months ended March 31, 2008. The comparative decrease in expenditures for the first quarter of 2009 is mainly due to the accrual of liabilities in the first quarter of 2008 in relation to the separation agreement with our former President and Chief Executive Officer.

### Financial Income

Financial income was \$27,000 for the three months ended March 31, 2009, compared to \$4,000 for the three months ended March 31, 2008. The increase in financial income was due to foreign currency fluctuations during the respective periods and changes in the fair value of forward contracts. From time to time, we enter into forward contracts to hedge certain sales transactions which are denominated in foreign currencies.

### Net Income (Loss)

For the three months ended March 31, 2009, we had net income of \$169,000, or 7.0% of revenues, compared to a net loss of \$161,000, or 5.1% of revenues, for the three months ended March 31, 2008. The increase in net income is due to primarily a significant increase in gross margins.

## LIQUIDITY AND CAPITAL RESOURCES

On March 31, 2009, we had cash and cash equivalents and restricted cash of \$1,828,000 and working capital of \$3,594,000. This compares with cash and cash equivalents of \$1,621,000 and working capital of \$3,417,000 at March 31, 2008. The increase in working capital in 2009 is mainly due to an increase in cash, and decreases in accounts payable and related parties payables, offset partially by a decrease in accounts receivable and an increase in deferred revenue and other current liabilities.

Cash used by operating activities totaled \$727,000 for the three months ended March 31, 2009, compared to cash provided by operating activities of \$52,000 for the three months ended March 30, 2008. The decrease in cash flow from operating activities in 2009 was mainly due to a decrease in accounts payable and related parties trade payables (due to the timing of certain payments to vendors), offset partially by increase in net income.

Net cash used in investing activities was \$17,000 for the three months ended March 31, 2009, compared to net cash provided by investing activities of \$18,000 for the three months ended March 31, 2008. In 2008, cash provided by investing activities was due to proceeds received from our landlord for leasehold improvements completed and

expensed during the prior quarter in our new location in Fremont, California. In 2009, cash was used to purchase certain property and equipment.

No cash was provided by or used in financing activities in either of the three-month periods ended March 31, 2009 or March 31, 2008.

Our liquidity will be affected by many factors, some of which are based on normal ongoing operations of our business and some of which arise from fluctuations related to global economics and markets. As evidenced by the recent turmoil in the financial markets, credit has tightened. We are reviewing our liabilities and capital structure to minimize any impact, and will pursue a strategy to mitigate any reductions in cash flow as a result of an economic slowdown by reducing capital expenditures and other discretionary spending. We currently believe that our existing cash balances, together with anticipated cash flows from operations, will be sufficient to fund our operations through at least the next twelve months..

- 14 -

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## CRITICAL ACCOUNTING POLICIES

In our Annual Report on Form 10-K for the year ended December 31, 2008, we identified the critical accounting policies which affect our more significant estimates and assumptions used in preparing our consolidated financial statements. The basis for developing the estimates and assumptions within our critical accounting policies is based on historical information and known current trends and factors. The estimates and assumptions are evaluated on an ongoing basis and actual results have been within our expectations. We have not changed these policies from those previously disclosed in our Annual Report.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable for a smaller reporting company.

## ITEM 4T. CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer, after evaluating our disclosure controls and procedures (as defined in the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 (the "Exchange Act")) as of the end of the period covered by this quarterly report, have concluded that as of such date, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

### Changes in Internal Controls over Financial Reporting

During the period covered by this quarterly report, there were no significant changes in our internal controls over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

See our disclosures under "Legal Proceedings" in our Annual Report on Form 10-K, filed March 31, 2009. There have been no material developments in those proceedings since that filing.

## ITEM 1A. RISK FACTORS

The risk factors listed in this section provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. Readers should be aware that the occurrence of any of the events described in these risk factors could have a material and adverse effect on our business, results of operations and financial condition. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

Although we experienced operating income during the quarter ended March 31, 2009 and the year ended December 31, 2008, we have historically experienced net losses and may experience net losses in the future.

For the quarter ended March 31, 2009, we had operating income of \$142,000, compared to an operating loss of \$165,000 for the quarter ended March 31, 2008. For the year ended December 31, 2008, we had operating income of

\$391,000. Although we have actively taken steps to reduce our costs, we could incur losses in the future until we increase revenues through the sale of current products and decrease manufacturing costs through a greater use of contract manufacturers in Asia and other strategic locations.

- 15 -

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We depend on Telkoor to design and manufacture many of our products.

We depend on Telkoor, our largest shareholder and one of our third party subcontractors, for design and manufacturing capabilities for many of the products which we sell. If Telkoor is unable or unwilling to continue designing or manufacturing our products in required volumes on a timely basis, that could lead to loss of sales, and adversely affect our operating results and cash position. We also depend on Telkoor's intellectual property and ability to transfer production to third party manufacturers. Failure to obtain new products in a timely manner or delay in delivery of product to customers will have an adverse effect on our ability to meet our customers' expectations. In addition, we operate in highly competitive markets where our ability to sell Telkoor's products could be adversely affected by long lead-times and the high costs of Telkoor's products. Telkoor's principal offices, research and development and manufacturing facilities are located in Israel. Political, economic, and military conditions in Israel directly affect Telkoor's operations.

Our strategic focus on our custom power supply solution competencies and concurrent cost reduction plans may be ineffective or may limit our ability to compete.

As a result of our strategic focus on custom power supply solutions, we will continue to devote significant resources to developing custom products for a large number of customers, where each product represents a uniquely tailored solution for a specific customer's requirements. A failure to meet these customer product requirements or a failure to meet production schedules and/or product quality standards may put us at risk with one or more of these customers. The loss of one or more of our significant custom power supply solution customers could have a material adverse impact on our revenues, business or financial condition.

We have also implemented a series of initiatives designed to increase efficiency and reduce costs. While we believe that these actions will reduce costs, they may not be sufficient to achieve the required operational efficiencies that will enable us to respond more quickly to changes in the market or result in the improvements in our business that we anticipate. In such event, we may be forced to take additional cost-reducing initiatives, which may negatively impact quarterly earnings and profitability as we account for severance and other related costs. In addition, there is the risk that such measures could have long-term effects on our business by reducing our pool of talent, decreasing or slowing improvements in our products or services, making it more difficult for us to respond to customers, limiting our ability to increase production quickly if and when the demand for our solutions increases and limiting our ability to hire and retain key personnel. These circumstances could cause our earnings to be lower than they otherwise might be.

If our new custom products development efforts fail to result in products which meet our customers' needs, or if our customers fail to accept our new products, our revenues will be adversely affected.

We have recently introduced a new strategy of developing multiple custom product designs. The successful development, introduction and commercial success of this new technology will depend on a number of factors, including our ability to meet customer requirements, our ability to meet all product criteria, successful transition from development stage to production stage, our ability to meet product cost targets generating acceptable margins, timely remediation of product performance issues, if any, identified during testing, product performance at customer locations, differentiation of our product from our competitors' products, and management of customer expectations concerning product capabilities and life cycles. If we fail to accomplish all of the above, our business could be materially and adversely affected.

We are dependent upon our ability to attract, retain and motivate our key personnel.

Our success depends on our ability to attract, retain and motivate our key management personnel, including but not limited to our CEO and CFO, controller, sales force, and key engineers, necessary to implement our business plan and to grow our business. Despite the adverse economic conditions at this time and occurring over the past several years,



competition for certain specific technical and management skill sets is intense. If we are unable to identify and hire the personnel that we need to succeed, or if one or more of our present key employees were to cease to be associated with us, our future results could be adversely affected.

- 16 -

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We depend upon a few major customers for a majority of our revenues, and the loss of any of these customers, or the substantial reduction in the quantity of products that they purchase from us, would significantly reduce our revenues and net income.

We currently depend upon a few major OEMs and other customers for a significant portion of our revenues. Because of the global economic downturn, we have already experienced the reduction of orders by OEMs and the reduction or cancellation of orders, scaling back of certain activities and workforce layoffs by other customers. The loss of any of these customers or a substantial reduction in the quantity of products that they purchase from us would significantly reduce our revenues and net income. Furthermore, diversions in the capital spending of certain of these customers to new network elements have and could continue to lead to their reduced demand for our products, which could in turn have a material adverse affect on our business and results of operation. If the financial condition of one or more of our major customers should deteriorate, or if they have difficulty acquiring investment capital due to any of these or other factors, a substantial decrease in our revenues would likely result.

We are dependent on the electronic equipment industry, and accordingly will be affected by the impact on that industry of the current economic downturn.

Substantially all of our existing customers are in the electronic equipment industry and they manufacture products that are subject to rapid technological change, obsolescence, and large fluctuations in demand. This industry is further characterized by intense competition and volatility. The OEMs serving this industry 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 current economic downturn has affected the entire supply chain, including us. Recently, certain segments of the electronic industry 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.

Our reliance on subcontract manufacturers to manufacture certain aspects of our products involves risks, including delays in product shipments and reduced control over product quality.

Since we do not own significant manufacturing facilities, we must rely on, and will continue to rely on, a limited number of subcontract manufacturers to manufacture our power supply products. Our reliance upon such subcontract manufacturers involves several risks, including reduced control over manufacturing costs, delivery times, reliability, quality of components, unfavorable currency exchange fluctuations, and continued inflationary pressures on many of the raw materials used in the manufacturing of our power supply products. If we were to encounter a shortage of key manufacturing components from limited sources of supply, or experience manufacturing delays caused by reduced manufacturing capacity, inability of our subcontract manufacturers to procure raw materials, the loss of key assembly subcontractors, difficulties associated with the transition to our new subcontract manufacturers or other factors, we could experience lost revenues, increased costs, delays in, cancellations or rescheduling of orders or shipments, any of which would materially harm our business.

We face intense industry competition, price erosion and product obsolescence, which, in turn, could reduce our profitability.

We operate in an industry that is generally characterized by intense competition. We believe that the principal bases of competition in our markets are breadth of product line, quality of products, stability, reliability and reputation of the provider, along with cost. Quantity discounts, price erosion, and rapid product obsolescence due to technological improvements are therefore common in our industry as competitors strive to retain or expand market share. Product obsolescence can lead to increases in unsaleable inventory that may need to be written off and therefore could reduce our profitability. Similarly, price erosion can reduce our profitability by decreasing our revenues and our gross margins. In fact, we have seen price erosion over the last several years on most of the products we sell, and we have

factored additional price erosion into our forecasts.

Our future results are dependent on our ability to establish, maintain and expand our OEM relationships and our other distribution channels.

We market and sell our products through domestic and international OEM relationships and other distribution channels. Our future results are dependent on our ability to establish, maintain and expand our relationships with OEMs as well as with other marketing and sales distribution channels. If, however, the third parties with whom we have entered into such OEM and other arrangements should fail to meet their contractual obligations, cease doing, or reduce the amount of their business with us or otherwise fail to meet their own performance objectives, customer demand for our products could be adversely affected, which would have an adverse effect on our revenues.

- 17 -

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We may not be able to procure necessary key components for our products, or we may purchase too much inventory or the wrong inventory.

The power supply industry, and the electronics industry as a whole, can be subject to business cycles. During periods of growth, key components required to build our products may become unavailable in the timeframe required for us to meet our customers' demands. Our inability to secure sufficient components to build products for our customers could negatively impact our sales and operating results. We may choose to mitigate this risk by increasing the levels of inventory for certain key components. Increased inventory levels can increase the potential risk for excess and obsolescence should our forecasts fail to materialize or if there are negative factors impacting our customers' end markets. If we purchase too much inventory or the wrong inventory, we may have to record additional inventory reserves or write-off the inventory, which could have a material adverse effect on our gross margins and on our results of operations.

We depend on sales of our legacy products for a meaningful portion of our revenues, but these products are mature and their sales will continue to decline.

A large portion of our sales have historically been attributable to our legacy products. We expect that these products may continue to account for a meaningful percentage of our revenues for the foreseeable future. However, these sales are declining. Although we are unable to predict future prices for our legacy products, we expect that prices for these products will continue to be subject to significant downward pressure in certain markets for the reasons described above. Accordingly, our ability to maintain or increase revenues will be dependent on our ability to expand our customer base, increase unit sales volumes of these products and to successfully, develop, introduce and sell new products such as custom design and value added products. We cannot assure you that we will be able to expand our customer base, increase unit sales volumes of existing products or develop, introduce and/or sell new products.

Our operating results may vary from quarter to quarter.

Our operating results have in the past been subject to quarter to quarter fluctuations, and we expect that these fluctuations will continue, and may increase in magnitude, in future periods. Demand for our products is driven by many factors, including the availability of funding for our products in customers' capital budgets. There is a trend for some of our customers to place large orders near the end of a quarter or fiscal year, in part to spend remaining available capital budget funds. Seasonal fluctuations in customer demand for our products driven by budgetary and other reasons can create corresponding fluctuations in period-to-period revenues, and we therefore cannot assure you that our results in one period are necessarily indicative of our revenues in any future period. In addition, the number and timing of large individual sales and the ability to obtain acceptances of those sales, where applicable, has been difficult for us to predict, and large individual sales have, in some cases, occurred in quarters subsequent to those we anticipated, or have not occurred at all. The loss or deferral of one or more significant sales in a quarter could harm our operating results. It is possible that in some quarters our operating results will be below the expectations of public market analysts or investors. In such events, or in the event adverse conditions prevail, the market price of our common stock may decline significantly.

We are subject to certain governmental regulatory restrictions relating to our international sales.

Some of our products are subject to (International Trafficking and Arms Regulation (ITAR) regulation, which is administered by the U.S. Department of State. ITAR controls not only the export, import and trade of certain products specifically designed, modified, configured or adapted for military systems, but also the export of related technical data and defense services as well as foreign production. Any delays in obtaining the required export, import or trade licenses for products subject to the ITAR could have a materially adverse effect on our business, financial condition, and/or operating results. In addition, changes in United States export and import laws that require us to obtain additional export and import licenses or delays in obtaining export or import licenses currently being sought could

cause significant shipment delays and, if such delays are too great, could result in the cancellation of orders. Any future restrictions or charges imposed by the United States or any other country on our international sales or foreign subsidiary could have a materially adverse effect on our business, financial condition, and/or operating results. In addition, from time to time, we have entered into contracts with the Israeli Ministry of Defense which were funded with monies subject to, and we therefore were required to comply with the regulations governing, the U.S. Foreign Military Financing program.

- 18 -

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We depend on international operations for a substantial majority of our components and products.

We purchase a substantial majority of our components from foreign manufacturers and have a substantial majority of our commercial products assembled, packaged, and tested by subcontractors located outside the United States. These activities are subject to the uncertainties associated with international business operations, including trade barriers and other restrictions, changes in trade policies, governmental regulations, currency exchange fluctuations, reduced protection for intellectual property, war and other military activities, terrorism, changes in social, political, or economic conditions, and other disruptions or delays in production or shipments, any of which could have a materially adverse effect on our business, financial condition, and/or operating results.

We depend on international sales for a portion of our revenues.

Sales to customers outside of North America accounted for 55.7% of net revenues in the year ended December 31, 2008, and we expect that international sales will continue to represent a material portion of our total revenues. International sales are subject to the risks of international business operations as described above as well as generally longer payment cycles, greater difficulty collecting accounts receivable, and currency restrictions. In addition, Gresham, our wholly-owned foreign subsidiary in the United Kingdom, supports our European and other international customers, distributors, and sales representatives, and therefore is also subject to local regulation. International sales are also subject to the export laws and regulations of the United States and other countries.

If our accounting controls and procedures are circumvented or otherwise fail to achieve their intended purposes, our business could be seriously harmed.

We evaluate our disclosure controls and procedures as of the end of each fiscal quarter, and are annually reviewing and evaluating our internal controls over financial reporting in order to comply with SEC rules relating to internal control over financial reporting adopted pursuant to the Sarbanes-Oxley Act of 2002. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. If we fail to maintain effective internal control over financial reporting or our management does not timely assess the adequacy of such internal control, we may be subject to regulatory sanctions and our reputation may decline.

The sale of our products is dependent upon our ability to satisfy the proprietary requirements of our customers.

We depend upon a relatively narrow range of products for the majority of our revenue. Our success in marketing our products is dependent upon their continued acceptance by our customers. In some cases, our customers require that our products meet their own proprietary requirements. If we are unable to satisfy such requirements, or forecast and adapt to changes in such requirements, our business could be materially harmed.

The sale of our products is dependent on our ability to respond to rapid technological change, including evolving industry-wide standards, and may be adversely affected by the development, and acceptance by our customers, of new technologies which may compete with or reduce the demand for our products.

Rapid technological change, including evolving industry standards, could render our products obsolete. To the extent our customers adopt such new technology in place of our products; the sales of our products may be adversely affected. Such competition may also increase pricing pressure for our products and adversely affect the revenues from such products.

Our limited ability to protect our proprietary information and technology may adversely affect our ability to compete, and our products could infringe upon the intellectual property rights of others, resulting in claims against us the results

of which could be costly.

Many of our products consist entirely or partly of proprietary technology owned by us. Although we seek to protect our technology through a combination of copyrights, trade secret laws and contractual obligations, these protections may not be sufficient to prevent the wrongful appropriation of our intellectual property, nor will they prevent our competitors from independently developing technologies that are substantially equivalent or superior to our proprietary technology. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. In order to defend our proprietary rights in the technology utilized in our products from third party infringement, we may be required to institute legal proceedings. If we are unable to successfully assert and defend our proprietary rights in the technology utilized in our products, our future results could be adversely affected.

- 19 -

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Although we attempt to avoid infringing known proprietary rights of third parties in our product development efforts, we may become subject to legal proceedings and claims for alleged infringement from time to time in the ordinary course of business. Any claims relating to the infringement of third-party proprietary rights, even if not meritorious, could result in costly litigation, divert management's attention and resources, require us to reengineer or cease sales of our products or require us to enter into royalty or license agreements which are not advantageous to us. In addition, parties making claims may be able to obtain an injunction, which could prevent us from selling our products in the United States or abroad.

If we are unable to satisfy our customers' specific product quality, certification or network requirements, our business could be disrupted and our financial condition could be harmed.

Our customers demand that our products meet stringent quality, performance and reliability standards. We have, from time to time, experienced problems in satisfying such standards. Defects or failures have in the past, and may in the future occur relating to our product quality, performance and reliability. From time to time, our customers also require us to implement specific changes to our products to allow these products to operate within their specific network configurations. If we are unable to remedy these failures or defects or if we cannot affect such required product modifications, we could experience lost revenues, increased costs, including inventory write-offs, warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments and product returns or discounts, any of which would harm our business.

If we ship products that contain defects, the market acceptance of our products and our reputation will be harmed and our customers could seek to recover their damages from us.

Our products are complex, and despite extensive testing, may contain defects or undetected errors or failures that may become apparent only after our products have been shipped to our customers and installed in their network or after product features or new versions are released. Any such defect, error or failure could result in failure of market acceptance of our products or damage to our reputation or relations with our customers, resulting in substantial costs for both the Company and our customers as well as the cancellation of orders, warranty costs and product returns. In addition, any defects, errors, misuse of our products or other potential problems within or out of our control that may arise from the use of our products could result in financial or other damages to our customers. Our customers could seek to have us pay for these losses. Although we maintain product liability insurance, it may not be adequate.

Our common stock price is volatile.

Our common stock is listed on the NYSE Amex 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. The exercise of outstanding options and warrants may adversely affect our stock price and a shareholder's percentage of ownership. As of March 31, 2009, we have outstanding options to purchase an aggregate of 779,035 shares of common stock, with a weighted average exercise price of \$1.01 per share, exercisable at prices ranging from \$0.48 to \$2.375 per share.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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



None.

- 20 -

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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.
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.

Dated: May 14, 2009

Digital Power Corporation

By: /s/ Amos Kohn  
Amos Kohn  
President & Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Uri Friedlander  
Uri Friedlander  
Chief Financial Officer  
(Principal Financial and Accounting Officer)