DIGITAL POWER CORP

FORM 10QSB
(Quarterly Report of Financial Condition)

Filed 11/13/1998 For Period Ending 9/30/1998

Address	41920 CHRISTY ST
	FREMONT, California 94538
Telephone	510-657-2635
CIK	0000896493
Industry	Electronic Instr. & Controls
Sector	Technology
Fiscal Year	12/31

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 September 30, 1998

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

COMMISSION FILE NUMBER 1-12711

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

California (State or other jurisdiction of incorporation or organization)	94-1721931 (IRS Employer Identification No.)

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

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

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

Number of shares of common stock outstanding as of September 30, 1998: 2,761,435

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
SEPTEMBER 30, 1998

ASSETS

CURRENT ASSETS:

Cash	$ 539,205
Accounts receivable - trade, net of allowance for doubtful accounts of $200,000	3,503,742
Other receivables	209,490
Inventory, net	6,468,980
Prepaid expenses and deposits	323,839
Deferred income taxes	141,139
Total current assets	11,186,395
PROPERTY AND EQUIPMENT, net	1,421,075
GOODWILL, net	1,479,656
DEPOSITS	24,427
TOTAL ASSETS	$ 14,111,553

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Current debt	$ 1,750,000
Current portion of long-term debt	91,946
Current portion of capital lease obligations	8,989
Accounts payable	1,543,958
Accrued liabilities	2,067,378
Total current liabilities	5,462,271
LONG-TERM DEBT, less current portion	115,313
LONG-TERM DEFERRED INCOME TAX LIABILITY	32,227
Total liabilities	5,609,811
COMMITMENTS AND CONTINGENCIES	-
STOCKHOLDERS' EQUITY:	
Series A cumulative redeemable convertible preferred stock, no par value, 2,000,000 shares authorized; 0 shares issued and outstanding	-
Common Stock, no par value, 10,000,000 shares authorized; 2,761,435 shares issued and outstanding	8,776,851
Warrants	96,678
Additional paid-in capital	400,260
Accumulated deficit	(906,553)
Unearned employee stock ownership plan shares	(207,259)
Foreign currency translation adjustment and other	341,765
Total stockholders' equity	8,501,742
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 14,111,553

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1997	1998	1997
REVENUES	$ 4,677,219	$ 5,185,938	$ 14,307,580	$ 14,008,640
COST OF GOODS SOLD	3,389,856	3,947,611	10,460,360	10,590,416
Gross Margin	1,287,363	1,238,327	3,847,220	3,418,224
OPERATING EXPENSES				
Engineering and product development	249,898	232,865	791,017	648,694
Marketing and selling	417,780	180,053	1,131,895	461,141
General and administrative	417,119	165,626	1,111,946	601,552
Total operating expenses	1,084,797	578,544	3,034,858	1,711,387
INCOME FROM OPERATIONS	202,566	659,783	812,362	1,706,837
OTHER INCOME (EXPENSES):				
Interest income	11,677	7,325	13,666	38,088
Interest expense	(60,511)	(14,509)	(175,586)	(57,859)
Translation loss	(17,096)	(908)	(32,056)	(15,015)
Other income (expense)	(65,930)	(8,092)	(193,976)	(34,786)
INCOME BEFORE INCOME TAXES	136,636	651,691	618,386	1,672,051
PROVISION FOR INCOME TAXES	53,100	242,905	236,000	661,800
NET INCOME	83,536	408,786	382,386	1,010,251
Other comprehensive income:				
Foreign currency translation adjustment	53,843	-	123,937	-
Income tax benefit from exercise of stock options	19,000	-	19,000	-
Comprehensive income	$ 156,379	$ 408,786	$ 525,323	$ 1,010,251
NET INCOME PER SHARE				
BASIC	$ 0.03	$ 0.16	$ 0.14	$ 0.40
DILUTED	$ 0.03	$ 0.11	$ 0.12	$ 0.29

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	NINE MONTHS ENDED SEPTEMBER 30, 1998	NINE MONTHS ENDED SEPTEMBER 30, 1997
Cash Flows from Operating Activities:		
Net income	$ 382,386	$ 1,010,251
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	266,672	104,446
Allowance for doubtful accounts	(35,000)	
Gain on disposal of asset	(16,648)	
Deferred income taxes	(37,234)	(67,700)
Compensation recognized upon issuance of stock or stock options	48,032	
Contribution to ESOP	118,164	112,403
Foreign currency translation adjustment	32,056	15,015
Changes in operating assets and liabilities:		
Accounts receivable	683,057	(448,456)
Other receivables	67,059	(80,149)
Inventory	(882,891)	(352,692)
Prepaid expenses	(194,589)	(14,100)
Other assets		(10,116)
Deposits	(7,167)	
Accounts payable	(1,543,150)	(157,162)
Accrued liabilities	1,021,537	(354,043)
Net adjustments	(480,102)	(1,252,554)
Net cash used in operating activities	(97,716)	(242,303)
Cash Flows from Investing Activities:		
Acquisition of Gresham Power Electronics	(3,370,293)	
Purchases of property and equipment	(88,752)	(338,989)
Proceeds from sale of asset	19,673	
Net cash used in investing activities	(3,439,372)	(338,989)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock and warrants		951,278
Proceeds from exercise of stock options including related tax benefits	156,506	85,500
Payments on long-term debt	(118,164)	
Principal payments on notes payable		(247,883)
Payments on capital lease obligations	(9,212)	(9,955)
Proceeds from line of credit	1,750,000	1,990,000
Principal payments on line of credit		(3,187,330)
Net cash provided by financing activities	1,779,130	(418,390)

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)

	NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1997
Effect of Exchange Rate Changes on Cash	91,881	(15,015)
Net (Decrease) in cash	(1,666,077)	(1,014,697)
Cash and cash equivalents, beginning of period	2,205,282	2,955,299
Cash and cash equivalents, end of period	$ 539,205	$ 1,940,602
Supplemental non-cash investing and financing activities:		
Acquisition of fixed assets with debt	$ 147,857	$ -
Supplemental Cash Flow Information:		
Cash payments for:		
Interest	$ 168,633	$ 66,727
Income taxes	$ 290,812	$ 847,402

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 1998

(UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 1997.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments consisting only of normal recurring accruals considered necessary to present fairly the Company's financial position at September 30, 1998, the results of operations for the three month and nine month periods ended September 30, 1998 and 1997, and cash flows for the nine months ended September 30, 1998 and 1997. The results for the period ended September 30, 1998, are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 1998.

On January 26, 1998, the Company acquired the assets of Gresham Power Electronics, a division of Gresham Lion Technology Ltd., a United Kingdom corporation. The Company paid U.S. $2.7 million cash plus earn-out and acquisition costs. The cash consideration may be increased by U.S. $1.6284 for each pound that the net asset value (NAV) exceeds U.K. (pound)1,100,000 and decreased in the same way. The NAV was determined as of January 26, 1998, and was equal to the value of fixed assets, accounts receivable, and inventory, less the value of agreed liabilities. From the transfer date of January 26, 1998, to June 30, 1998, an accounting was done and additional consideration was paid as follows: (a) U.S. $1.15 for every pound of earnings before interest, taxes, and purchaser group charges in excess of U.K. (pound)250,000 up to a maximum payment of U.S. $300,000; and (b) U.S. $300,000 in the event that the post-compensation NAV equaled or exceeded U.K. (pound) 1,000,000. The additional aggregate consideration due under the agreement was calculated to be U.S. $371,978. As a result of the acquisition, the financial statements for the period ended September 30, 1998, are not comparable to the financial statements for the period ended September 30, 1997.

The Company has filed a Form 8-K announcing this acquisition. However, the required audited financial statements and pro forma financial information have not been filed and will be filed as soon as practicable.

NOTE 2 - EARNINGS PER SHARE

The following represents the calculation of earnings per share:

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,		FOR THE NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1997	1998	1997
BASIC				
Net Income	$ 83,536	$ 408,786	$ 382,386	$ 1,010,251
Less - preferred stock dividends	-	-	-	-
Net income applicable to common shareholders	$ 83,536	$ 408,786	$ 382,386	$ 1,010,251
Weighted average number of common shares	2,734,837	2,596,054	2,712,778	2,540,996
Basic earnings per share	$ 0.03	$ 0.16	$ 0.14	$ 0.40
DILUTED				
Net income applicable to common shareholders	$ 83,536	$ 408,786	$ 382,386	$ 1,010,251
Preferred stock dividend	-	-	-	-
Net income available to common shareholders plus assumed conversion	$ 83,536	$ 408,786	$ 382,386	$ 1,010,251
Weighted average number of common shares	2,734,837	2,596,054	2,712,778	2,540,996
Common stock equivalent shares representing shares issuable upon exercise of stock options	252,763	529,218	350,730	490,410
Common stock equivalent shares representing shares issuable upon exercise of warrants	-	447,923	3,161	380,997
Weighted average number of shares used in Calculation of diluted income per share	2,987,600	3,573,195	3,066,669	3,412,403
Diluted earnings per share	$ 0.03	$ 0.11	$ 0.12	$ 0.29

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, a high degree of customer concentration, dependence on the computer and other electronic equipment industry, competition in the power supply industry, dependence on the Guadalajara, Mexico facility, and other risks factors detailed in the Company's Securities and Exchange Commission ("SEC") filings including the "Certain Considerations" section in the Company's Form 10-KSB for the year ended December 31, 1997. 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.

THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 1998, COMPARED TO SEPTEMBER 30, 1997

REVENUES

Revenues decreased by 9.8% to $4,677,219 for the three months ended September 30, 1998, from $5,185,938 for the three months ended September 30, 1997. Revenues from the Company's United Kingdom's operations of Digital Power Ltd. were $1,679,703 for the third quarter ended September 30, 1998. However, revenues attributed to the United States operations decreased by 42.2% from the same quarter during the prior year. The decrease in revenues during the three months ended September 30, 1998, can be attributed to the loss of the Company's largest customer at the end of 1997. Although this customer had some minor purchases during the first quarter of 1998, no purchases were recorded during the three months ended September 30, 1998. As previously reported, this same large OEM customer cancelled a contract in late 1997. This customer was billed cancellation charges for the cost of unique materials assemblies. After negotiations between the Company and the OEM, the Company and the OEM agreed to an amount of cancellation charges which are included in revenues. These non-reoccurring cancellation charges amounted to approximately 9.2% of revenues for the three months ended September 30, 1998. In addition, the electronics industry is experiencing some softness in the demand for the Company's products which adversely affected the Company's revenues during the third quarter.

For the nine months ended September 30, 1998, revenues increased by 2.1% to $14,307,580 from $14,008,640 for the nine months ended September 30, 1997. The increase in revenues during the nine months ended September 30, 1998, can be attributed to the acquisition of Gresham Power in the United Kingdom on January 26, 1998. For the nine months ended September 30, 1998, Gresham Power contributed $5,185,152 to the Company's revenues.

GROSS MARGINS

Gross margins were 27.5% for the three months ended September 30, 1998, compared to 23.9% for the three months ended September 30, 1997. The increase in gross margins can be attributed to greater shipments of higher margin products and to the non-reoccurring cancellation charges previously discussed. Although gross margins related to the cancellation charges are higher than other products, they do not reflect engineering costs, vendor cancellation fees, and other carrying costs associated with the contract which were previously expensed.

Gross margins were 26.9% for the nine months ended September 30, 1998, compared to 24.4% for the nine months ended September 30, 1997. The improvement in gross margins can be attributed to greater shipments of high margin products and the non-reoccurring cancellation charges discussed above.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses were 17.9% of revenues for the three months ended September 30, 1998, compared to 6.7% for the three months ended September 30, 1997. Selling, general and administrative expenses were 15.7% of revenues for the nine months ended September 30, 1998, compared to 7.6% for the nine months ended September 30, 1997. The increase is due, in part, to the inclusion of selling, general and administrative expenses related to the acquisition of Gresham Power in January 1998. In addition, during the third quarter ended September 30, 1998, the Company further reduced the number of workers at its plant located in Guadalajara, Mexico, and, near the end of the quarter, reduced work hours at the Fremont, CA facility to bring operating expenses in line with the current revenue levels.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 5.3% of revenues for the three months ended September 30, 1998, and 4.5% for the three months ended September 30, 1997. Engineering and product development expenses were 5.5% of revenues for the nine months ended September 30, 1998, compared to 4.6% for the nine months ended September 30, 1997. The increase in engineering and product development is a result of an effort by the Company to develop new products for its customers. The increase is due primarily to the engagement of engineering consultants to help develop new products.

INTEREST EXPENSE

Interest expense, net of interest income, was $48,834 for the three months ended September 30, 1998, compared to $7,184 for the three months ended September 30, 1997. Interest expense, net of interest income, was $161,920 for the nine months ended September 30, 1998, compared to $19,771 for the nine months ended September 30, 1997. The increase in interest expense related to the increase in borrowing used to acquire Gresham Power.

INCOME BEFORE INCOME TAXES

For the three months ended September 30, 1998, the Company had an income before income taxes of $136,636 compared to income before income taxes of $651,691 for the three months ended September 30, 1997. For the nine months ended September 30, 1998, the Company had an income of before income taxes of $618,386 compared to $1,672,051 for the nine months ended September 30, 1997.

INCOME TAX

Provision for income tax decreased from $242,905 for the three months ended September 30, 1997, to $53,100 for the three months ended September 30, 1998, and from $661,800 for the nine months ended September 30, 1997, to $236,000 for the nine months ended September 30, 1998, as a result of a lower pre-tax income during the three and nine months ended September 30, 1998.

NET INCOME

Net income for the three months ended September 30, 1998, was $83,536 compared to $408,786 for the three months ended September 30, 1997, a decrease of 79.6%. Net income for the nine months ended September 30, 1998, was $382,386, compared to $1,010,251 for the nine months ended September 30, 1997, a decrease of 62.1%. The decrease in net income was due to decreased revenues during the third quarter ended September 30, 1998, primarily related to the Company's United States operations, and an increase in expenses related to severance payments made to laid-off workers in Mexico.

LIQUIDITY AND CAPITAL RESOURCES

On September 30, 1998, the Company had cash of $539,205 and working capital of $5,724,124. This compares with cash of $1,940,602 and working capital of $6,184,782 at September 30, 1997. The decrease in working capital was due to an increase in inventory and decrease of accounts payable, offset by a decrease in accounts receivable and increase in bank line of credit borrowings, resulting in a decrease in cash and cash equivalents, although the decrease in cash is related to cash used to acquire Gresham Power. Cash used in operating activities for the Company totaled $78,716 and $242,303 for the nine months ended September 30, 1998 and 1997.

Cash used in investing activities was $3,439,372 for the nine months ended September 30, 1998, compared to $338,989 for the nine months ended September 30, 1997. During the nine months ended September 30, 1998, the Company completed the acquisition of Gresham Power. Net cash provided by (used in) financing activities was $1,760,130 for the nine months ended September 30, 1998, compared to ($418,390). During the nine months ended September 30, 1998, the Company borrowed $1,750,000 from the bank in connection with the acquisition of Gresham Power.

On September 3, 1998, the Company entered into a Technology Transfer Agreement with KDK Electronics, Inc. ("KDK"). Under the terms of the Technology Transfer Agreement, the Company acquired from KDK the technology and right to sell in the future, products that may be derived from a design acquisition agreement dated November 10, 1987, and agreement dated June 29, 1990, between KDK and the Company. For the acquisition of the technology and future sales rights, the Company issued 35,000 shares of its common stock and will pay $140,000 in $7,000 monthly payments, beginning in October 1998.

IMPACT OF THE YEAR 2000 ISSUE

The Year 2000 Issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's, or its suppliers' and customers' computer programs that have date-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in system failures or miscalculations causing disruptions of operations including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

The Company has recently acquired new software and has been informed by its suppliers that such software used by the Company is Year 2000 compliant. The software from these suppliers is used in major areas of the Company's operations such as for financial, sales, warehousing and administrative purposes. The

Company has no internally generated software. In connection with the acquisition of Gresham Power, the Company has determined that Gresham Power's existing software will not be Year 2000 compliant, and has acquired hardware and software to address the Year 2000 Issue at a cost of approximately $200,000. The Company anticipates that Gresham Power will complete the installation of the hardware and software during the first part of 1999. Other than Gresham Power, and after reasonable investigation, the Company has not yet identified any other Year 2000 problem but will continue to monitor the issue. However, there can be no assurances that the Year 2000 problem will not occur with respect to the Company's computer systems.

During the third quarter of 1998, the Company initiated formal communications with significant suppliers and large customers to determine the extent to which those third parties' failure to remedy their own Year 2000 Issues would materially effect the Company and its subsidiaries. The Company has not received any indication from its suppliers and large customers that the Year 2000 Issue may materially effect their ability to conduct business.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

As previously reported on Form 10-QSB for the quarter ended March 31, 1998, the Company is involved in certain litigation. During the quarter ended September 30, 1998, the Company settled the complaint filed in the Superior Court of California In and For the County of Santa Clara (Case No. CV773108) by KDK Electronics, Inc. ("KDK"). On September 3, 1998, the Company and KDK settled the lawsuit. Under the terms of the settlement agreement, the Company paid KDK $10,000 and each party bore its own expenses.

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 AND REPORTS ON FORM 8-K

10.7 Technology Transfer Agreement with KDK Electronics, Inc.

27.1 Financial Data Schedule

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DIGITAL POWER CORPORATION
(Registrant)

Date: November 13, 1998	ROBERT O. SMITH
	Robert O. Smith Chief Executive Officer (Principal Executive Officer)
Date: November 13, 1998	PHILIP G. SWANY
	Philip G. Swany Chief Financial Officer (Principal Financial Officer)

TECHNOLOGY TRANSFER AGREEMENT

1. Parties. The parties ("the Parties") to this technology transfer agreement ("this Agreement") are Digital Power Corporation ("Digital") on the one hand, and Ki Dong Kang ("Kang") and KDK Electronics, Inc. ("KDK"), on the other.

2. Effective Date. This Agreement is effective September 3, 1998 ("the Effective Date").

3. Recitals.

3.1. Digital has entered into certain agreements with Kang and KDK ("the Agreements"), consisting of,

a) a certain design acquisition agreement dated November 10, 1987 between Digital and Kang, a copy of which is attached hereto as Exhibit 1.

b) a certain agreement dated June 29, 1990 between KDK and Digital, a copy of which is attached hereto as Exhibit 2.

c) all other agreements between or among Digital, Kang, and KDK on or before September 2, 1998.

3.2. Digital wishes to acquire, from Kang and KDK, the clear right, in perpetuity, to use, without the payment of any further royalties or other consideration of any kind, other than that provided under this Agreement, certain technology received from Kang and KDK.

3.3. Digital believes that the technology to be acquired by this Agreement will have substantial value to it over a period of at least five years.

3.4. As a result of the foregoing, and for valuable consideration, including the mutual covenants in this Agreement, the Parties agree as follows:

4. Covenants.

4.1. Payment. Digital will pay a total of one hundred forty thousand dollars ($140,000) to KDK and will issue a total of thirty five thousand shares of its common stock (the "Stock") to Kang and Soonho Kim Kang. The one hundred forty thousand dollars ($140,000) will be paid as follows:

a) $7,000 due September 15, 1998,

b) $7,000 due November 1, 1998,

c) $10,000 due January 1, 1999, and

d) $7,000, or such lesser amount as may be necessary to pay the entire balance, due on the first of each month thereafter until the entire one hundred forty thousand dollars ($140,000) is paid.

There will be a three day grace period after each due date during which the payment may be made without penalty or interest. Thereafter, Digital will incur simple interest of ten percent per annum on any overdue amounts.

The Stock will be issued to Kang and Soonho Kim Kang as community property as of the Effective Date. The certificates will be issued within one hundred twenty (120) days of the Effective Date. The Parties agree that, for accounting and tax purposes, the value of the Stock will be the closing price as reported in the Wall Street Journal as of the Effective Date.

4.2. Technology Transfer. Digital, its successors, and its assigns shall forever have the right to produce, sell, incorporate, and otherwise use all products, designs, technology, and intellectual property that it may have received from Kang or KDK, pursuant to the Agreements or otherwise, in any way that it wishes, without limitation and without any obligation of any kind to Kang, KDK, or anyone else. All contrary provisions of the Agreements are hereby revoked and superseded. Without limitation, under no circumstances will Digital be obligated to pay any royalty, grant any option, or transfer any stock to Kang or KDK other than any payment or transfer that may be required under this Agreement. All obligations of Digital of any kind to Kang or KDK other than those in this Agreement are hereby canceled, revoked, and superseded.

4.3. Restricted Securities. In order to enable Digital to comply with the federal Securities Act of 1933 and applicable state laws, Digital may require Kang and Soonho Kim Kang, as a condition of the issuance of the Stock, to give written assurances satisfactory to Digital, and Kang does hereby represent, that the Shares are being acquired for their own account, for investment only, with no view to the distribution of the same, and that any disposition of all or any portion of the shares shall not be made, unless and until:

(a) There is then in effect a registration statement under the Securities Act covering such proposed disposition and such disposition is made in accordance with such registration statement; or

(b)(i) Kang has notified Digital of the proposed disposition and he has furnished Digital with a detailed statement of the circumstances surrounding the proposed disposition, and (ii) Kang has furnished Digital with an opinion of counsel, reasonably satisfactory to Digital, that such disposition will not require registration of such securities under the Securities Act and applicable state law.

Kang acknowledges that the Shares will be restricted securities, that it understands the provisions of Rule 144 of the Securities and Exchange Commission, and that the certificate or certificates evidencing such shares of Common Stock will bear a legend substantially similar to the following:

"The Shares represented by this certificate have not been registered under the Securities Act of 1933, as amended, or under the securities laws of any state. They may not be sold,~transferred, or otherwise disposed of in the absence of an effective registration statement covering these securities under the said Act or laws, or an opinion of counsel satisfactory to Digital and its counsel that registration is not required thereunder."

4.4. Adjustment for Changes in Capitalization. This Agreement shall not affect Digital's right to effect adjustments, recapitalizations, reorganizations, or other changes in its or any other corporation's capital structure or business, any merger or consolidation, any issuance of bonds, debentures, preferred or prior preference stock ahead of or affecting the Shares, the dissolution or liquidation of Digital's or any other corporation's assets or business, or any other corporate act, whether similar to the events described above or otherwise. If, before the certificate for the Shares is issued to Kang and Soonho Kim Kang, the outstanding shares of Digital's common stock are increased or decreased in number or changed into or exchanged for a different number or kind of securities of Digital or any other corporation by reason of a recapitalization, reclassification, stock split, reverse stock split, combination of shares, stock dividend, or other similar event, an appropriate adjustment of the number of the Shares issued under this Agreement will be made to preserve the proportional beneficial interest in the assets of Digital represented, as of the Effective Date, by the Shares.

5. Representations and Warranties.

5.1. Authority. The Parties represent and warrant that they, through the signatories indicated below, are duly authorized to enter into this Agreement, to make its warranties and representations, to perform its covenants, and to fulfill its conditions, and that none of the rights, claims, or obligations being transferred under this Agreement, have been conveyed, assigned, or otherwise transferred to anyone who is not a Party to this Agreement.

5.2. Reading. Each of the Parties represents that it has carefully read and understood this entire Settlement Agreement before executing it.

5.3. Legal Representation. Each of the Parties acknowledges and agrees that it has been represented in the preparation of this Agreement by legal counsel of its. choosing. Each of the Parties further acknowledges the receipt of the advice of independent legal counsel prior to the execution of this Agreement, that the legal nature and effect of this Agreement has been fully explained to it by counsel, and that it fully understands the terms and provisions of this Agreement, its nature, and its effect. Each of the Parties further represents that it is relying solely on the advice of its own counsel in executing this Agreement and has neither received nor relied upon any representation or opinion of any of the other Parties or of the counsel of any of the other Parties, except for the representations contained in this Agreement.

5.4. No Other Representations. The Parties represent that none of the other Parties to this Agreement or their representatives have given them any legal, factual, or other representations or opinions relating to this Agreement other than those expressly contained in it.

6. Notice. Except as may be provided otherwise elsewhere in this Agreement, any election, delivery, notice, or communication required or permitted under this Agreement shall be in writing and shall be deemed to have been given if placed in the United States mail to the following addresses, or such other addresses as the Parties may later specify in writing. Except as may be provided otherwise elsewhere in this Agreement, notwithstanding any defect in the method of delivery that prevents it from being effective upon mailing, such an election, delivery, notice, or other communication, if it is in writing, shall be deemed given if and when it is actually received by such of the Parties as are entitled to receive it.

If to Digital, to:

Bob Smith
Digital Power Corporation
41920 Christy Street
Fremont, CA 94538-3158

With a copy to:

Daniel B. Eng
Bartel Eng Linn & Schroder
300 Capitol Mall, Suite 1100
Sacramento, California 95814

If to KDK, to:

Ki Dong Kang
15520 On Orbit Drive
Saratoga, California 95070

with a copy to:

Harold W. Fryday
Attorney at Law
P.O. Box 637
Santa Clara, CA 95052-0637

7. Integration. This Agreement constitutes the entire agreement among the Parties concerning its subject matter and supersedes all prior or contemporaneous contracts, agreements, understandings, negotiations, and discussions of the Parties, whether oral or written, concerning its subject matter.

8. Expenses of Matters Settled. Each of the Parties shall bear its own costs of suit, attorneys' fees, and other expenses related to the matters being settled, and no Party shall make any payment or reimbursement, or provide any consideration, other than what may be described in this Agreement.

9. No Other Agreements. The Parties affirm that other than this Agreement, any contracts, agreements, or understandings among the Parties, on any subject whatever, including but not limited to promissory notes, employment contracts, and other contracts that may have been entered into on or before September 1, 1998 are terminated. Any agreements entered into on or after September 3, 1998 will survive.

10. No Oral Modification. No amendment, supplement, modification, waiver, or termination of this Agreement shall be binding unless it contained in a writing signed by the party against whom the amendment, supplement, modification, waiver, or termination is being asserted.

11. Successors and Assigns. This Agreement shall be binding on and inure to the benefit of the heirs, executors, administrators, trustees, successors, assigns, and transferees of the respective Parties.

12. Drafting. Each of the Parties represents that this Agreement has been negotiated through its counsel and jointly drafted and agrees that any ambiguity in it shall not be construed against any of them.

13. Expenses of Enforcement. In any litigation arising out of or relating to this Agreement, the prevailing party shall be entitled to its reasonable expenses, attorneys' fees, and costs, in addition to any other remedy that may be available.

14. Counterparts. This Agreement may be executed in counterparts, and each executed counterpart shall be deemed to be a duplicate original of this Agreement.

DIGITAL POWER CORPORATION

DATED: 9/8/98

By: /s/ Robert Smith
Robert Smith
Chief Executive Officer

KDK ELECTRONICS, INC.

DATED: 9/3/98 *By: /s/ Ki Dong Kang*
Ki Dong Kang
President

DATED: 9/3/98 *By: /s/ Ki Dong Kang*
Ki Dong Kang
Individually

Approved as to form:

BARTEL ENG LINN & SCHRODER
A Law Corporation

DATED: 9/3/98 *By: /s/ Vincent DiCarlo*
Vincent DiCarlo
Attorneys for Digital Power Corporation

DATED: 9/3/98 *By: /s/ Harold W. Fryday*
Harold W. Fryday
Attorney for KDK Electronics, Inc.

CAMERLENGO & JOHNSON

DATED: 9/3/98 *By: /s/ George F. Camerlengo*
George F. Camerlengo
Attorneys for KDK Electronics, Inc.

ARTICLE 5

(Replace this text with the legend)

PERIOD TYPE	9 MOS
FISCAL YEAR END	DEC 31 1998
PERIOD END	SEP 30 1998
CASH	539,205
SECURITIES	0
RECEIVABLES	3,703,742
ALLOWANCES	(200,000)
INVENTORY	6,468,980
CURRENT ASSETS	11,186,395
PP&E	2,524,971
DEPRECIATION	(1,103,896)
TOTAL ASSETS	14,111,553
CURRENT LIABILITIES	5,462,271
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	8,776,851
OTHER SE	(275,109)
TOTAL LIABILITY AND EQUITY	14,111,553
SALES	14,307,580
TOTAL REVENUES	14,307,580
CGS	10,460,380
TOTAL COSTS	10,460,380
OTHER EXPENSES	3,034,858
LOSS PROVISION	0
INTEREST EXPENSE	(175,586)
INCOME PRETAX	618,386
INCOME TAX	236,000
INCOME CONTINUING	382,386
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	382,386
EPS PRIMARY	0.14
EPS DILUTED	0.12

End of Filing