

DIGITAL POWER CORP

FORM 10KSB

(Annual Report (Small Business Issuers))

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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-KSB

(Mark One)

☒ **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934** For the fiscal year ended December 31, 1998

☐ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934** For the transition period from _____ to _____

DIGITAL POWER CORPORATION

(Exact name of registrant as specified in its charter)

California	3679	94-1721931
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code)	(I.R.S. Employer Identification No.)

41920 Christy Street, Fremont, California 94538-3158; 510-657-2635
(Address and telephone number of principal executive offices)

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

Title of Each Class	Name of Each Exchange on Which Registered
----- Common Stock	----- American Stock Exchange

Redeemable Common Stock Purchase Warrants American Stock Exchange

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

Title of Each Class
None

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. ☐

Revenues for the year ended December 31, 1998, were \$18,733,470.

As of February 26, 1999, the aggregate market value of the voting common stock held by non-affiliates was approximately \$4,617,495 based on the average bid and ask price of \$1.81 per share.

As of February 26, 1999, the number of shares of common stock outstanding was 2,771,435.

Documents incorporated by reference: Items 9 through 12 of Part III of this Form 10-KSB are incorporated by reference to Digital's definitive Proxy Statement for the 1999 annual shareholders' meeting to be filed with the Commission within 120 days from the end of the year.

Transitional Small Business Disclosure Format (check one): Yes ☐ No ☒

Exhibit index is located on page 21.

With the exception of historical facts stated herein, the following discussion may contain forward-looking statements regarding events and financial trends which may affect the Company's future operating results and financial position. Such statements are subject to risks and uncertainties that could cause the Company's actual results and financial position to differ materially from those anticipated in such forward-looking statements. Factors that could cause actual results to differ materially include, in addition to other factors identified in this report, a high degree of customer concentration, the loss of a key customer, dependence on the computer and electronic equipment industries, competition in the power supply industry, dependence on Guadalajara, Mexico facility, and dependence on key personnel, all of which factors are set forth in more detail in the sections entitled "Certain Considerations" and "Management's Discussion and Analysis or Plan of Operation" herein. Readers of this report are cautioned not to put undue reliance on "forward looking" statements which are, by their nature, uncertain 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.

Part I.

Item 1. Description of Business

General

Digital Power ("Digital Power" or the "Company") designs, develops, manufactures, and sells 50 watt to 750 watt switching power supplies and DC/DC converters to original equipment manufacturers (OEMs) of computers and other electronic equipment. Power supplies are critical components of electronic equipment that supply, convert, distribute, and regulate electrical power. The various subsystems within electronic equipment require a steady supply of direct current (DC) electrical power, usually at different voltage levels from the other subsystems within the equipment. In addition, the electronic components and subsystems require protection from the harmful surges and drops in electrical power that commonly occur over power lines. Power supplies satisfy these requirements by converting alternating current (AC) electricity into DC by dividing a single input voltage into distinct and isolated output voltages, and by regulating and maintaining such output voltages within a narrow range of values.

Products which convert AC from a primary power source into DC are generally referred to as "power supplies." Products which convert one level of DC voltage into a higher or lower level of DC voltage are generally referred to as "DC/DC converters." "Switching" power supplies are distinguished from "linear" power supplies by the manner and efficiency with which the power supply "steps down" voltage levels. A linear power supply converts an unregulated DC voltage to a lower regulated voltage by "throwing away" the difference between the two voltages as heat. Consequently, the linear power supply is inherently inefficient-typically only 45% efficient for a 5V output regulator. By contrast, a switching power supply converts an unregulated DC voltage to a lower regulated voltage by storing the difference in a magnetic field. When the magnetic field grows to a pre-determined level, the unregulated DC is switched off and the output power is provided by the energy stored in the magnetic field. When the field is sufficiently depleted, the unregulated DC is switched on again to deliver power to the output while the excess voltage is again stored in the magnetic field. As a result, the switching power supply is more efficient-typically 75% efficient for a 5V output regulator.

One of the great advantages of switching power supplies, in addition to their high efficiency, is their high power density, or power-to-volume ratio. This density is the result of the reduction in the size of the various components. Because the Company's switching power supply products have a high power density, they are generally smaller than those of competitors. For example, to the Company's knowledge its US100 series of power supplies, on a 3"x 5" printed circuit board, is the smallest 100 watt off-line (AC input) power supply available in the industry.

Another advantage of the Company's power supply products is their extreme flexibility of design. The Company has purposely designed its base model power supply products so that they can be quickly and inexpensively modified and adapted to the specific power supply needs of any OEM. This "flexibility" approach has allowed the Company to provide samples of modified power supplies to OEM customers in only a few days after initial consultation, an important capability given the emphasis placed by OEMs on "time to market." In addition, this "flexibility" approach results in very low non-recurring engineering (NRE) expenses. Because of its reduced NRE expenses, the Company does not charge its OEM customers for NRE related to tailoring a power supply to a customer's specific requirements. This gives the Company a distinct advantage over its competitors, many of whom do charge their customers for NRE expenses. The Company's marketing strategy is to exploit this combination of high power density, design flexibility, and short time-to-market to win an increasing share of the growing power supply market.

In addition to the line of proprietary products offered, and in response to requests from OEMs, the Company also provides "value-added services" along with its products. The term "value-added services" refers to the Company's incorporation of an OEM's selected electronic components, enclosures, and cable assemblies with the Company's power supply products to produce a power subassembly that is compatible with the OEM's own equipment and is specifically tailored to meet the OEM's needs. The Company purchases the parts and components that the OEM itself would otherwise attach to or integrate with the Company's power supply, and the Company provides the OEM with that integration and installation service, thus saving the OEM time and money. The Company believes that this value-added service is well-suited to those OEMs who wish to reduce their vendor base and minimize their investment in fixed costs since the OEMs are not required to manufacture their own power subassemblies and thus are not required to purchase individual parts from many vendors or build assembly facilities.

Digital Power Corporation is a California corporation originally formed in 1969 through a predecessor. Unless the context indicates otherwise, any reference to "Digital Power" or the "Company" herein includes its majority-owned Mexican subsidiary, Poder Digital S.A. de C.V. and its United Kingdom subsidiary, Digital Power Limited, dba Gresham Power Electronics. Further, unless otherwise indicated, reference to dollars in this Annual Report shall mean United States dollars.

1998 Activity

At the end of calendar year 1997, the Company was informed by its then largest customer that it would cease making purchases of power supplies from the Company. That customer accounted for approximately 24.4% of the Company's total sales during 1997. Further, during calendar year 1998, there was a softness in the overall market for power supplies. As a result during 1998, the Company experienced a substantial decrease in revenues of approximately \$7 million from its United States operations. The decrease in revenues, however, was offset by revenues acquired through the acquisition of certain assets of Gresham Power Electronics in January 1998 discussed below. The Company is conducting business

in Europe through its wholly-owned subsidiary Digital Power Limited, dba Gresham Power Electronics ("Gresham Power"). In addition, the Company had certain adverse adjustments to its cost of goods sold due to obsolescence and price erosion of the Company's inventory. Finally, during 1998, the Company increased its research and development expenditures to develop new products. Due to all of these factors, the Company incurred a net loss of \$570,588 during 1998.

Gresham Power

Pursuant to an Asset Sale Agreement (the "Agreement"), on January 22, 1998, Digital Power acquired the assets of Gresham Power Electronics from Gresham Lion Technology Limited, an English corporation ("Gresham Lion"). The consideration paid for the acquisition was \$2.7 million, which amount is subject to adjustment depending upon the net asset value (accounts receivables, fixed assets and inventory less liabilities) ("NAV") as of the closing date. Specifically, pursuant to the Agreement, the acquisition amount shall be increased by \$1.6284 for each United Kingdom pound that Gresham Power's NAV exceeds UK(pound)1,100,000 as of the closing date, and shall be reduced by \$1.6284 for each United Kingdom pound that the NAV is less than UK(pound)1,100,000 as of the closing date. In addition to the foregoing, if the NAV as of March 31, 1998, equals or exceeds UK(pound)1,606,000, Gresham Lion shall be paid an additional \$300,000 subject to a reduction of \$1.6284 for every United Kingdom pound NAV is less than UK(pound)1,606,000. Further, Digital Power shall pay Gresham Lion an additional \$1.15 for every United Kingdom pound of earnings before interest and taxes which exceeds UK(pound)250,000, up to a maximum additional payment of \$300,000. As a result of primarily Gresham Power's NAV as of the closing date, and, to a lesser extent, Gresham Power achieving certain earnings, Digital Power paid an additional \$371,978 in the aggregate to Gresham Lion.

Headquartered in Salisbury, England, Gresham Power designs, manufactures, and distributes switching power supplies, uninterruptible power supplies, and frequency converters for the commercial and military markets. Uninterruptible power supplies (UPS) are devices that are inserted between a primary power source and the primary power input of the electronic equipment to be protected for the purpose of eliminating the effects of transient anomalies or temporary outages. A UPS consists of an inverter that is powered by a battery that is kept trickle-charged by rectified AC from an incoming power line. In the event of a power interruption, the battery takes over without the loss of even a fraction of a cycle in the AC output of the UPS. The battery also provides protection against transients. A frequency converter is an electronic unit for speed control of a phase induction motor. The frequency converter controls the motor speed by converting the frequency and voltage of the power main's supply from fixed to variable values. This is the most efficient means of varying the fixed speed of an induction motor, since other methods involve great power losses or great investments. The acquisition of Gresham Power will diversify the Company's product line, provide greater access to the United Kingdom and European markets, and strengthen Digital's engineering and technical resources.

The Market

Since all electronic equipment requires power supplies, the overall market for power supplies is very large. The growth of the power supply industry has paralleled that of the general electronics industry. Since 1994, growth has escalated at an even faster pace, fueled by the demand for networking communications equipment and computing equipment and its peripherals. Future growth is expected to come from the same markets, as internet and intranet

networking and cellular and digital telephones continue to become popular around the world.

The electronic power supply market is typically split into "captive" and "merchant" market segments. The captive segment of the market, that portion represented by OEMs who design and manufacture power supplies for use in their own products. The remaining power supply market is served by merchant power supply manufacturers, such as Digital Power, that design and manufacture power supplies for sale to OEMs.

The Company believes that the merchant market is the fastest growing segment of the power supply market, as OEMs continue to outsource their power supply requirements. The Company believes that this increase is due, in part, to the fact that power supplies are becoming an increasingly complex component in the eyes of OEMs, with constantly changing requirements such as power factor correction (PFC) and filtering specifications to minimize electromagnetic interference (EMI).

The power supply market can also be divided between "custom" and "standard" power supplies. Custom power supplies are those that are customized in design and manufactured with a specific application in mind, whereas standard power supplies are sold off-the-shelf to customers whose electronic equipment can operate from standard output voltages such as 5, 12, or 24 volts. Power supplies in the captive market that are designed and manufactured by an OEM for use in its own equipment are an example of a custom design, as the product is not intended for resale. However, custom power supplies are also common in the merchant market, as certain OEMs contract with power supply manufacturers to design a product that meets the form, fit, and function requirements of that OEM's specific application. A subset of the standard segment of the market has evolved, commonly known as "modified standard" segment, comprising power supply products that have the performance characteristics of a standard power supply, but require certain, usually minor, modifications. These modifications typically involve an adjustment to one of the standard output voltages, such as from 5 volts to 7 volts, or from 15 volts to 18.5 volts.

The power supply industry is highly fragmented. There are approximately 300 domestic merchant power supply competitors in the United States, with over 200 that generate less than \$5 million in revenues. No one manufacturer holds more than five percent of the total market. The merchant market segment is also highly fragmented according to the power level, technology, packaging, or application of a merchant's particular power supply. Most merchant manufacturers concentrate on niche markets, whether power ranges or industry segments.

With no industry standards for power supplies, it is very difficult to design out an existing power supply component which prevents large companies from quickly gaining market share. The key to being a profitable manufacturer is to have long-term expertise in power electronics and to be able to provide products needed by customers. The Company has targeted and serves the industrial and office automation, industrial and portable computing, and networking applications niches of the merchant market. The Company believes that its focus on high-efficiency, high-density, design-flexible power supplies is ideally suited to the rapid growth opportunities existing in this market segment.

Geographically, Digital Power primarily serves the North American power electronics market with AC/DC power supplies and DC/DC converters ranging from 50 watts to 750 watts of total output power.

Gresham Power serves the United Kingdom marketplace with AC/DC power supplies, uninterruptible power supplies, and frequency inverters. Both commercial and government (Ministry of Defense) markets are served by Gresham Power.

Customers

Digital Power's products are sold domestically and in Canada through a network of 14 manufacturers' representatives. Digital Power also has 23 stocking distributors in the United States and Europe. In addition, the Company has formed strategic relationships with three of its customers to private label its products. Digital Power's customers can generally be grouped into three broad industries, consisting of the computer, telecommunication, and instrument industries. The Company has a current base of over 150 active customers, including companies such as Ascend Communications, Telex, Storage Dimensions, Motorola, Stanford Telecommunications, Extreme Network, Ericsson and British Telecom.

Strategy

Digital Power's strategy is to be the supplier of choice to OEMs requiring a high-quality power solution where size, rapid modification, and time-to-market are critical to business success. Target market segments include telecommunications, networking, switching, mass storage, and industrial and office automation products. While many of these segments would be characterized as computer-related, the Company does not participate in the personal computer (PC) power supply market because of the low margins arising out of the high volume and extremely competitive nature of that market.

The Company intends to continue its sales primarily to existing customers while simultaneously targeting sales primarily to new customers. The Company believes that its "flexibility" concept allows customers a unique choice between its products and products offered by other power supply competitors. OEMs have typically had to settle for a standard power supply product with output voltages and other features predetermined by the manufacturer. Alternatively, if the OEM's product required a different set of power supply parameters, the OEM was forced to design this modification in-house, or pay a power supply manufacturer for a custom product. Since custom-designed power supplies are development-intensive and require a great deal of time to design, develop, and manufacture, only OEMs with significant volume requirements can economically justify the expense and delay associated with their production. Furthermore, since virtually every power conversion product intended for use in commercial applications requires certain independent safety agency testing at considerable expense, such as by Underwriters Laboratories, an additional barrier is presented to the smaller OEM. By offering the OEM customer a new choice with the Digital Power "flexibility" series, the Company believes it has an advantage over its competitors. The Company's "flexibility" series is designed around a standardized power platform, but allows the customer to specify output voltages tailored to its exact requirements within specific parameters. Furthermore, OEMs are seeking power supplies with greater power density. Digital Power's strategy in responding to this demand has been to offer increasingly smaller power supply units or packages.

Product Strategy and Products

Digital Power has nine series of base designs from which thousands of individual models can be produced. Each series has its own printed circuit board (PCB) layout that is common to all models within the series regardless of the number of output voltages (typically one to four) or the rating of the

individual output voltages. A broad range of output ratings, from 3.3 volts to 48 volts, can be produced by simply changing the power transformer construction and a small number of output components. Designers of electronic systems can determine their total power requirements only after they have designed the system's electronic circuitry and selected the components to be used in the system. Since the designer has a finite amount of space for the system and may be under competitive pressure to further reduce its size, a burden is placed on the power supply manufacturer to maximize the power density of the power supply. A typical power supply consists of a PCB, electronic components, a power transformer and other electromagnetic components, and a sheet metal chassis. The larger components are typically installed on the PCB by means of pin-through-hole assembly where the components are inserted into pre-drilled holes and soldered to electrical circuits on the PCB. Other components can be attached to the PCB by surface mount interconnection technology (SMT) which allows for a reduction in board size since the holes are eliminated and components can be placed on both sides of the board. The Company's US100 series is an example of a product using this manufacturing technology.

Digital Power's "flexibility" concept applies to all of the Company's US, UP/SP, and DP product series. A common printed circuit board is shared by each model in a particular family, resulting in a reduction in parts inventory while allowing for rapid modifiability into thousands of output combinations. The following is a description of the Company's products.

The US50 series of power supplies consists of compact, economical, high efficiency, open frame switchers that deliver up to 50 watts of continuous power, or 60 watts of peak power, from one to four outputs. The 90-264 VAC universal input allows them to be used worldwide without jumper selection. Flexibility options include chassis and cover, power good signal, an isolated V4 output, and UL544 (medical) safety approval. All US50 series units are also available in 12VDC, 24VDC, or 48VDC inputs. This optional DC input unit (DP50 series) maintains the same pin-out, size, and mounting as the US50 series.

The US70 series of power supplies is similar to the US50 series, a compact, economical, highly efficient, open frame switcher that delivers up to 65 watts with a 70 watt peak. This unit is offered with one to four outputs, a universal input rated from 90 to 264 VAC, and is only slightly larger than the US50 series. The US70 series is differentiated from competitive offerings by virtue of its smaller size, providing up to four outputs while competitors typically are limited to three outputs. Flexibility options include cover, power good signal, an isolated V4 output, and UL544 (medical) safety approval. The DP70 is the same as the US70 except the input is 48 volts DC. The Company also offers 12 & 24VDC DC input on this series where the model series changes to DN & DM. This type of product is ideal for low profile systems, with the power supply measuring 3.2" x 5" x 1.5".

The US100/DP100 is the industry's smallest 100 watt switcher. Measuring only 5" x 3.3" x 1.5", this series delivers up to 100 watts of continuous power, or 120 watt peak power, from one to four outputs. The 90-264VAC universal input allows them to be used worldwide. This product is ideal in applications where OEMs have upgraded their systems, requiring an additional 30-40 watts of output power but being unable to accommodate a larger unit. The US100 fits in the same form factor and does not require any tooling or mechanical changes by the OEM. Flexibility options include a cover and adjustable post regulators on V3 and/or V4 outputs. Fully customized models are also available. All US100 series units are also available with 12VDC, 24VDC, or 48 VDC inputs. This optional DC input unit (DP100) maintains the same pin-out, size, and mounting as the US100 series.

The UP300 series consists of economical, high efficiency, open frame switchers that deliver up to 300 watts of continuous, or 325 watts of peak power, from one to two outputs. The 115/230VAC auto-selectable input allows them to be used worldwide. On-board EMI filtering is a standard feature. Flexibility options include a cover, power fail/power good signal, and an isolated 2nd output. The UP300 is also available as the SP300 series, which is jumper selectable between 115 and 230VAC and provides the OEM an even more economical solution. This product can be used in network switching systems or other electronic systems where a lot of single output current, such as 5, 12, 24, or 48 volt current might be required.

The US250 series consists of economical, high efficiency, open frame switchers that deliver up to 250 watts of continuous power, or 300 watts of peak power, from one to four outputs. The 115/230VAC auto-selectable input allows them to be used worldwide. Flexibility options include cover, power fail/power good signal, enable/inhibit, and an isolated V3 output. All US250 series units are also available with 12VDC, 24VDC, or 48VDC inputs. This optional DC input unit (DP250) maintains the same pin-out, size, and mounting as the US250 series.

The US350 series is a full-featured unit that has active power factor correction and was designed to be field-configurable by the Company's international and domestic sales channels. This feature allows the stocking distributor to lower its inventory costs but still maintain the required stock to rapidly provide power supplies with the unique combination of output voltages required by an OEM. This unit delivers 350 watts from one to four output modules and meets the total harmonic distortion spec IEC 555.2. The US350 has an on-board EMI filter and operates from 90-264 VAC input. This unit measures 9" x 5" x 2.5". It can operate without any minimum loads and has an optional internal fan and power fail/power good signal.

The newest product developed by the Company is the UPF 150 series. The UPF 150 is an open-frame switcher that delivers up to 150watts of continuous power from one to four outputs. The UPF 150 is endowed with power factor correction and a Class B EMI filter, making the series particularly well-suited for those customers selling into the international market place.

The Company also produces two products designated as the KD series in a 150 watt and 200 watt product. These designs were licensed in 1987, and amended in 1990, under a licensing agreement with KDK Electronics. They are still offered for sale but are expected to continue to decline as a percentage of Digital Power's revenues. The licensing agreement with KDK Electronics, as amended, provides that KDK Electronics will be paid a royalty equal to 5% on the first \$20 million total sales of the KD series products with the royalty decreasing on sales over that amount. Further, in the event total historical sales of KD products reach \$20 million, then KDK Electronics will be granted a stock option to purchase 100,000 shares of Digital Power's common stock for \$3.50 per share with Digital Power paying the exercise price.

In connection with litigation involving KDK Electronics and the Company, on September 3, 1998, the Company entered into a Technology Transfer Agreement with KDK Electronics. Under the terms of the Technology Transfer Agreement, the Company acquired from KDK Electronics the technology and right to sell in the future products that may be derived under the 1987 licensing agreement, as amended, between KDK Electronics and the Company. For the acquisition of the technology and future sales rights and settlement of

litigation, the Company issued 35,000 shares of its common stock and will pay \$150,000 in \$7,000 monthly payments, beginning in October 1998. "See Item 3. Legal Proceedings."

Digital Power offers its customers various types of value-added services, which may include the following additions to its standard product offerings:

Electrical (power): Paralleled power supplies for (N+1) redundancy, hot swapability, output OR'ing diodes, AC input receptacle with fuse, external EMI filter, on/off switch, cabling and connectors, and battery backup with charger.

Electrical (control and monitoring): AC power fail detect signal, DC output(s) OK signal, inhibit, output voltage margining, and digital control interface.

Mechanical: Custom hot-plug chassis for (N+1) redundant operation, locking handle, cover, and fan.

These services incorporate one of the Company's base products along with additional enclosures, cable assemblies, and other electronic components to arrive at a power subassembly. This strategy matches with those OEMS wishing to reduce their vendor base, as the turnkey sub-assembly allows customers to eliminate other vendors.

Other than certain fabricated parts such as printed circuit boards and sheet metal chassis which are readily available from many suppliers, the Company uses no custom components. Typically, two suppliers are qualified for every component, with the exception being one line transformer manufactured by Spitznagel. This transformer is designed into one of the Company's products, which accounted for less than 10% of the Company's total sales in 1998.

Manufacturing Strategy

Consistent with its product flexibility strategy, the Company aims to maintain a high degree of flexibility in its manufacturing processes in order to respond to rapidly changing market conditions. With few exceptions, the competitive nature of the power supply industry has placed continual downward pressure on selling prices. In order to achieve low cost manufacturing with a labor-intensive product, manufacturers have the option of automating much of the labor out of their product, or producing their product in a low labor cost environment. Given the high fixed costs of automation and the resistance this places on making major product changes, Digital Power believes that its flexible manufacturing strategy is best achieved through a highly variable cost of operation. In 1986, the Company established a wholly-owned subsidiary in Guadalajara, Mexico to assemble its products. This manufacturing facility performs materials management, sub-assembly, final assembly, and test functions for the majority of the Company's power supply products. Currently, almost all of the Company's manufacturing, including its value-added services, is done at a 16,000 square foot facility operated by the Company's wholly-owned subsidiary, Poder Digital, S.A. de C.V., located in Guadalajara, Mexico. In addition, Digital Power has entered into an agreement with Fortron/Source Corp. to manufacture Digital Power's products at a facility located in China on a turnkey basis. Purchases from Fortron/Source will be made pursuant to purchase orders and the agreement may be terminated upon 120 days notice. The Company is manufacturing approximately 15% of its product requirements through Fortron/Source and expects to increase these production levels due to cost

advantages achieved through Chinese procurement. The Company believes that the facility in China complements its manufacturing facility in Guadalajara, Mexico since the facility in China allows the Company to produce power supplies with sufficient lead time at lower costs, while the Guadalajara facility will continue to manufacture power supplies that need a quick turnaround or modification.

Sales, Marketing and Customers

During 1998, the Company had revenues of \$18,733,470 and a net loss of \$570,588 compared to revenues of \$18,884,259 and net income of \$1,400,790 during fiscal year 1997.

Digital Power markets its products through a network of thirteen domestic and one Canadian independent manufacturers' representatives. Each representative organization is responsible for managing sales in a particular geographic territory. Generally, the representative has exclusive access to all potential customers in the assigned territory and is compensated by commissions at 5% of net sales after the product is shipped, received, and paid for by the customer. Typically, either the Company or the representative organization may terminate the agreement with 30 days' written notice.

In certain territories, the Company has entered into agreements with 23 stocking distributors who buy and resell the Company's products. For the fiscal years ended December 31, 1998 and 1997, distributor sales accounted for 26.07% and 44.3%, respectively, of the Company's total sales. Over this same period, one distributor accounted for 13% and 24.9%, respectively, of total sales. In addition, international sales through stocking distributors accounted for less than 5% of the Company's sales. In general, the agreements with stocking distributors are subject to annual renewal and may be terminated upon 90 days' written notice. Although these agreements may be terminated by either party in the event a stocking distributor decides to terminate its agreement with the Company, the Company believes that it would be able to continue the sale of its products through direct sales to the customers of the stocking distributor. Further, and in general, stocking distributors are eligible to return 25% of their previous six- months' sales for stock rotation. For the past three years, stock rotations have not exceeded one percent of total sales.

The Company has also entered into agreements with three private label customers who buy and resell the Company's products. Under these agreements, the Company sells its products to the private label company who then resells the products with its label to its customers. The Company believes that these private label agreements expand its market by offering the customer a second source for the Company's products. The private label agreements may be terminated by either party. Further, the private label agreement requires that any product subject to a private label be available for five years. For the years ended December 31, 1998 and 1997, private label sales accounted for 8.0% and 13.9%, respectively, of total sales.

The Company's promotional efforts to date have included product data sheets, feature articles in trade periodicals, and trade shows. The Company's future promotional activities will likely include space advertising in industry-specific publications, a full-line product catalog, application notes, and direct mail to an industry-specific mail list.

The Company's products are warranted to be free of defects for a period ranging from one to two years from date of shipment. No significant warranty returns were experienced in either 1998 or 1997. As of December 31, 1998, the Company's warranty reserve was \$305,000.

Competition

The merchant power supply manufacturing industry is highly fragmented and characterized by intense competition. The Company's competition includes over 500 companies located throughout the world, some of whom have advantages over the Company in terms of labor and component costs, and some of whom may offer products comparable in quality to those of the Company. Certain of the Company's competitors, including Artesyn Technologies, Inc. (now merged with Zytec Corporation), ASTEC America, and Lambda Electronics, have substantially greater fiscal and marketing resources and geographic presence than does the Company. If the Company continues to be successful in increasing its revenues, competitors may notice and increase competition for the Company's customers. The Company also faces competition from current and prospective customers who may decide to design and manufacture internally the power supplies needed for their products. Furthermore, certain larger OEMs tend to contract only with larger power supply manufacturers. This factor could become more problematic to the Company if consolidation trends in the electronics industry continue and some of the OEMs to whom the Company sells its products are acquired by larger OEMs. To remain competitive, management believes that the Company must continue to compete favorably on the basis of value by providing advanced manufacturing technology, offering superior customer service and design engineering services, continuously improving quality and reliability levels, and offering flexible and reliable delivery schedules. The Company believes it has a competitive position with its targeted customers who need a high-quality, compact product which can be readily modified to meet the customer's unique requirements. However, there can be no assurance that the Company will continue to compete successfully in the power supply market.

Research and Development

The Company's research and development efforts are primarily directed toward the development of new standard power supply platforms which may be readily modified to provide a broad array of individual models. Improvements are constantly sought in power density, modifiability, and efficiency, while the Company attempts to anticipate changing market demands for increased functionality, such as PFC and improved EMI filtering. Internal research is supplemented through the utilization of consultants who specialize in various areas, including component and materials engineering and electromagnetic design enhancements to improve efficiency, while reducing the cost and size of the Company's products. Product development is performed at Digital Power's headquarters in California by three engineers who are supported and assisted by five technicians. The Company's total expenditures for research and development were \$1,397,816 and \$866,787 for the years ended December 31, 1998 and 1997, respectively, and represented 7.46% and 4.59% of the Company's total revenues for the corresponding periods.

Employees

As of December 31, 1998, the Company had approximately 340 full-time employees, with 255 of these employed at its wholly-owned subsidiary Poder Digital located in Guadalajara, Mexico, and 50 employed by Gresham Power. The employees of Digital Power's Mexican operation are members of a national labor

union, as are most employees of Mexican companies. The Company has not experienced any work stoppages at either of its facilities and believes its employee relations are good.

Guadalajara, Mexico Facility and Foreign Currency Fluctuations

The Company produces substantially all of its products at its 16,000 square foot facility located in Guadalajara, Mexico. The products are then delivered to Fremont, California for testing and distribution. The Company believes that it has a good working relationship with its employees in Guadalajara, Mexico and has recently signed a five-year contract with the union representing the employees. In 1997, the Company entered into a "turnkey" manufacturing contract with a manufacturer located in China to produce its products in an attempt to reduce its dependence on its Mexican facility. At this time the purchase of products from the manufacturer located in China accounts for approximately 15% of revenues and requires advance scheduling which affects the Company's ability to produce products quickly. However, if the Company's revenues grow as anticipated, the Company intends to manufacture more of its products utilizing the Chinese manufacturer. In the event that there is an unforeseen disruption at the Guadalajara production plant or with the Chinese manufacturer, such disruption may have an adverse effect on the Company's ability to deliver its products and may adversely affect the Company's financial operations.

Further, the Guadalajara, Mexico facility conducts its financial operations using the Mexican peso and Gresham Power conducts its financial operation using the United Kingdom pound. Therefore, due to financial conditions beyond the control of the Company, the Company is subject to monetary fluctuations between the U.S. dollar, Mexican peso, and United Kingdom pound. During fiscal 1998, the Company lost \$37,771 as a result of currency fluctuations.

CERTAIN CONSIDERATIONS

In addition to the other information presented in this report, the following should be considered carefully in evaluating the Company and its business. This report contains various forward-looking statements that involve risks and uncertainties. The Company's actual results may differ materially from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed below and elsewhere in this report.

Customer Concentration

Traditionally, the Company has relied on a limited number of customers for growth and increase in sales. For the fiscal year ended December 31, 1997, one OEM accounted for 24.9% of the Company's total revenues which subsequently ceased purchases during the fourth quarter of 1997. See "Management's Discussion and Analysis or Plan of Operation." For the year ended December 31, 1998, one OEM customer accounted for 13% of the Company's total revenue. The loss of any major OEM customers may have an adverse effect on the Company's revenues.

\$3 Million Credit Facility

The Company has entered into a \$3 million credit facility with San Jose National Bank. As of December 31, 1998, approximately \$1.6 million was outstanding. The credit facility bears interest based upon the lender's prime

rate, is due June 15, 1999, and is secured by all of the Company's assets. Under terms of the loan agreement, the Company is in technical default requiring that the Company be profitable on a quarterly basis and maintain certain debt to tangible net worth ratios. The Company has obtained a waiver of the covenants from the bank. However, in the event the Company continues to be unprofitable, no assurance can be given that the bank will continue to waive the covenants or renew the Company's loan.

Dependence on Computer and Other Electronic Equipment Industries; Customers' Product Obsolescence

Substantially all of the Company's existing customers are in the computer and other electronic equipment industries and produce products which are subject to rapid technological change, obsolescence, and large fluctuations in product demand. These industries are characterized by intense competition and a demand on OEMs serving these markets for increased product performance and lower product prices. Given this industry environment in which they operate, OEMs make similar demands on their suppliers, such as the Company, for increased product performance and lower product prices. Thus, in order to be successful, the Company must properly assess developments in the computer and other electronic equipment industries and identify product groups and customers with the potential for continued and future growth. Factors affecting the computer and other electronic equipment industries, in general, or any of the Company's major customers or their products, in particular, could have a material adverse effect on the Company's results of operations. In addition, the computer industry is inherently volatile. Recently, certain segments of the computer and other electronic industries have experienced a softening in demand for their products. Although this has not materially affected the Company's customers, in the event that it affects all segments of the computer and other electronic industries, the growth of the Company could be adversely affected.

Dependence on Guadalajara, Mexico Facility; Foreign Currency Fluctuations

The Company produces substantially all of its products at its facility located in Guadalajara, Mexico. The products are then delivered to Fremont, California for testing and distribution. The Company believes that it has a good working relationship with its employees in Guadalajara, Mexico and has signed a five-year contract with the union representing the employees. The Company has also entered into a "turnkey" manufacturing contract with a manufacturer located in China to produce its products in an attempt to reduce its dependence on its Mexican facility. At this time the purchase of products from the manufacturer located in China accounts for approximately 15% of revenues and requires advance scheduling which affects the Company's ability to produce products quickly. However, the Company may manufacture more of its products utilizing the Chinese manufacturer. In the event that there is an unforeseen disruption at the Guadalajara production plant or with the Chinese manufacturer, such disruption may have an adverse effect on the Company's ability to deliver its products and may adversely affect the Company's financial operations.

Dependence Upon Key Personnel

The Company's performance is substantially dependent on the performance of its executive officers and key personnel, and on its ability to retain and motivate such personnel. The loss of any of the Company's key personnel, particularly Robert O. Smith, Chief Executive Officer, could have a material adverse effect on the Company's business, financial condition, and operating results. The Company has "key person" life insurance policies on Mr. Smith in

the aggregate amount of \$2 million. The Company also has an employment agreement with Mr. Smith.

Dependence on Suppliers

In order to reduce dependence on any one supplier, the Company attempts to obtain two suppliers for each component of its products. However, for one line transformer in its product, the Company is dependent on a single supplier. Currently, this product accounts for less than 10% of the Company's total sales. Although the Company will seek to find other manufacturers of transformers for this product, unanticipated shortages or delays in these parts may have an adverse effect on the Company's results of operations.

No Patents

The Company's products are not subject to any U.S. or foreign patents. The Company believes that because its products are being continually updated and revised, obtaining patents would not be beneficial. Therefore, there can be no assurance that other competitors or former employees will not obtain the Company's proprietary information and develop it.

Item 2. Description of Properties.

The Company's headquarters are located in approximately 9,500 square feet of leased office, research and development space in Fremont, California. The Company pays \$5,890 per month, subject to adjustment, and the lease expires on January 31, 2001. The Company's manufacturing facility is located in 16,000 square feet of leased space in Guadalajara, Mexico. The Company pays approximately \$3,500 per month, subject to adjustment, and the lease expires in February 2001. Gresham Power leases approximately 25,000 square feet for its location in Salisbury, England. Gresham Power pays rent of approximately (pound)17,500 per quarter, and the lease will expire September 26, 2009. Gresham Power is currently negotiating to enter into a new lease with the landlord. The Company believes that its existing facilities are adequate for the foreseeable future and has no plans to expand them.

Item 3. Legal Proceedings.

On April 20, 1998, the Company was served with a complaint in the Superior Court of California in and for the County of Santa Clara (Case No. CV773108) by KDK Electronics, Inc. In its complaint, KDK Electronics alleged breach of contract, misappropriation of trade secrets, fraud, and negligent misrepresentation in connection with, among other things, the Company's alleged failure to pay KDK Electronics royalties on sales of products that were allegedly derived from KDK Electronic's designs, and for failure to issue 100,000 shares of the Company's Common Stock based on revenues from those products. KDK Electronic's complaint seeks economic damages of approximately \$300,000, punitive and exemplary damages, injunctive relief, attorneys' fees and costs.

In connection with litigation involving KDK Electronics and the Company, on September 3, 1998, the Company entered into a Technology Transfer Agreement with KDK Electronics. Under the terms of the Technology Transfer Agreement, the Company acquired from KDK Electronics the technology and right to sell in the future products that may be derived under the 1987 licensing agreement, as amended, between KDK Electronics and the Company. For the

acquisition of the technology and future sales rights and settlement of litigation, the Company issued 35,000 shares of its common stock and will pay \$150,000 in \$7,000 monthly payments, beginning in October 1998. Further, under the terms of the settlement agreement, each party bore its own expenses.

On March 17, 1998, a lawsuit was filed by Ignacio Valencia against the Company in the Superior Court of Santa Clara County (No. CV772665) alleging deceit and breach of contract. In the complaint, Mr. Valencia alleged that in 1986, Mr. Valencia moved his family to Guadalajara, Mexico on reliance that he would become president of Poder Digital S.A. de C.V. ("Poder"), the Company's wholly-owned subsidiary and would receive forty percent of the profits of Poder. Mr. Valencia claimed lost wages of \$52,000 and lost stock options of \$350,000 and punitive damages.

On February 12, 1999, the Company settled the lawsuit with Mr. Valencia. Under the terms of the settlement, the Company paid Mr. Valencia \$16,110 and will provide Mr. Valencia employment for six months at the hourly rate of \$18.50, 40 hours per week. Mr Valencia's term of employment will end on August 13, 1999. In connection with the settlement, Mr. Valencia dismissed his claim with prejudice.

Item 4. Submission of Matters to a Vote of Security Holders.

None

PART II

Item 5. Market for Common Equity and related Stockholder Matters.

(a) Comparative Market Prices

Digital Power's Common Stock and Redeemable Common Stock Purchase Warrants are listed and traded on the American Stock Exchange ("AMEX") under the symbols DPW and DPW+, respectively. Prior to being listed and traded on AMEX, Digital Power's Common Stock and Redeemable Common Stock Purchase Warrants were traded on the NASDAQ SmallCap Market. The following tables set forth the high and low closing sale prices, as reported by AMEX and/or NASDAQ SmallCap Market, for Digital Power's Common Stock and Warrants for the prior two fiscal years.

Common Stock

Period	Low	High
-----	---	----
Quarter ending December 31, 1998	\$1.38	\$2.94
Quarter ending September 30, 1998	\$1.63	\$5.44
Quarter ending June 30, 1998	\$4.25	\$6.69
Quarter ending March 31, 1998	\$5.75	\$7.00

Common Stock

Period -----	Low ---	High ----
Quarter ending December 31, 1997	\$6.25	\$9.75
Quarter ending September 30, 1997	\$9.63	\$11.38
Quarter ending June 30, 1997	\$7.50	\$10.25
Quarter ending March 31, 1997	\$5.25	\$8.50

Redeemable Common Stock Purchase Warrants

Period -----	Low ---	High ----
Quarter ending December 31, 1998	\$.13	\$.63
Quarter ending September 30, 1998	\$.25	\$.94
Quarter ending June 30, 1998	\$.75	\$2.19
Quarter ending March 31, 1998	\$1.00	\$2.25
Quarter ending December 31, 1997	\$1.69	\$4.63
Quarter ending September 30, 1997	\$4.50	\$6.13
Quarter ending June 30, 1997	\$2.88	\$5.00
Quarter ending March 31, 1997	\$1.50	\$3.75

(b) Holders

As of December 31, 1999, there were 2,771,435 shares of Digital Power common stock outstanding, held by approximately 124 holders of record, not including shareholders whose shares are held in street name. As of the same date, there were 838,090 warrants outstanding, with approximately 68 holders of record, not including warrant holders whose warrants are held in street name.

(c) Dividends

The Company has not declared or paid any cash dividends since its inception. The Company currently intends to retain future earnings for use in the operation and expansion of the business. The Company does not intend to pay any cash dividends in the foreseeable future. The declaration of dividends in the future will be at the discretion of the Board of Directors and will depend upon the earnings, capital requirements, and financial position of the Company.

Item 6. Management's Discussion and Analysis or Plan of Operation.

Overview

The Company designs, develops, manufactures, and markets electronic power supplies for use in converting electric power into a form suitable for the operation of electronic circuitry. Revenues are generated from the sale of the

Company's power supplies to OEMs in the computer and other electronic equipment industries.

In January 1998, the Company acquired certain assets of Gresham Power. Similar to Digital Power, Gresham Power designs, manufactures and distributes switching power supplies, uninterruptible power supplies and frequency converters for the commercial and military markets. As a result of the acquisition of Gresham Power, the Company's Consolidated Balance Sheet, Consolidated Statements of Income, Consolidated Statement of Stockholders' Equity and Consolidated Statements of Cash Flows for the year ended December 31, 1998, include the financial statements of Gresham Power from January 22, 1998, the date of acquisition.

Results of Operations

The table below sets forth certain statements of operations data as a percentage of revenues for the years ended December 31, 1998 and 1997.

	Years Ended December 31	
	1998	1997
	-----	-----
Revenues	100%	100%
Cost of goods sold	78.89	73.90
	-----	-----
Gross margin	21.11	26.10
Selling, general and administrative	16.73	8.44
Engineering and product development	7.46	4.59
	-----	-----
Total operating expense	24.19	13.03
	-----	-----
Operating income	(3.08)	13.07
Net interest expense	1.14	.11
Translation loss	.20	.11
	-----	-----
Income (Loss) before income taxes	(4.42)	12.85
Provision (Benefit) for income taxes	(1.37)	5.43
	-----	-----
Net (Loss) Income	(3.05%)	7.42%
	=====	=====

The following discussion and analysis should be read in connection with the Company's Consolidated Financial Statements and the notes thereto and other financial information included elsewhere in this report.

Year Ended December 31, 1998, Compared to Year Ended December 31, 1997

Revenues

Revenues for the fiscal year ended December 31, 1998, were \$18,733,470 which represented a decrease of \$150,789, or approximately 1%, from revenues of \$18,884,259 for the year ended December 31, 1997. The decrease in revenues was due primarily to the loss of the Company's largest customer which accounted for approximately 24.4% of the Company's revenues during 1997. This decrease in total revenues was offset by an increase in revenues of \$7,002,041 from Gresham Power which was acquired in January 1998.

Gross Margins

Gross margins were 21.11% for the year ended December 31, 1998 compared to 26.10% for the fiscal year ended December 31, 1997. This decrease in gross margins can be primarily attributed to an increase in cost of goods sold due to price erosion of inventory, the write off certain slow moving inventory, and the increase in warranty reserves.

Selling, General and Administrative

Selling, general and administrative expenses increased by \$1,540,446 to \$3,134,211 for the year ended December 31, 1998, from \$1,593,765 for the fiscal year ended December 31, 1997. Of the increase, \$1,289,006 is attributed to Gresham Power. The other additional increase is primarily related to an increase in provision of bad debts and for professional fees.

Engineering and Product Development

Engineering and product development expenses were \$1,397,816 for the year ended December 31, 1998, as compared to \$866,787 for the year ended December 31, 1997. Of the increase, \$280,514 is attributed to Gresham Power. The other additional increase can be attributed to expenses related to the development of the UPF 150 and another new product and to the settlement of litigation involving KDK Electronics.

Interest Expense

Net interest expense was \$220,894 for the year ended December 31, 1998, compared to \$21,542 for the year ended December 31, 1997. This increase in interest expense is primarily due to increased borrowings of approximately \$1,700,000 to acquire Gresham Power in January 1998.

Translation Loss

The primary currency of the Company's subsidiary, Poder Digital, is the Mexican peso and for Gresham Power, the United Kingdom pound. During 1998, the Company experienced a translation loss of \$37,771 primarily related to Poder Digital's operations using Mexican pesos, compared with a translation loss of \$19,846 in 1997.

(Loss) Income Before Income Taxes

The Company incurred a loss of (\$828,588) before income taxes during 1998 compared to income before income taxes of \$2,426,790 in 1997. This substantial decrease, as discussed above was due to the loss of the Company's largest customer during the end of 1997, softness in the power supply market, and erosion of the Company's gross margin, and increased research and developments expenses.

Income Tax

For the year ended December 31, 1998, the Company had an income tax benefit of \$258,000 due to its 1998 net loss compared to tax expense of \$1,026,000 for the year ended December 31, 1997.

Net (Loss) Income

Net loss was (\$570,588) in 1998 compared to net income of \$1,400,790 in 1997.

The Company does not believe that its business is seasonal.

Liquidity and Capital Resources

Through December 31, 1998, the Company funded its operations primarily through revenues generated from operations, and bank borrowings. As of December 31, 1998, the Company had cash and cash equivalents of \$867,607 and working capital of \$5,001,316. This compares with cash and cash equivalents of \$2,205,299 and working capital of \$7,050,144 at December 31, 1997. The decrease in working capital for the year ended December 31, 1998, is primarily due to the Company's loss and borrowings to acquire Gresham Power. Cash provided by (used in) operating activities for the Company totaled \$10,066 and \$(80,252) for the year ended December 31, 1998 and 1997, respectively. Cash used in investing activities of \$3,500,586 during 1998 consisted of primarily expenditures for the purchase of the assets of Gresham Power. During 1997, cash used in investing activities amounted to \$388,825 from the purchase of production and testing equipment. For the year ended December 31, 1998, cash flow from financing activities included proceeds from borrowings of \$2,366,846 offset by proceeds of \$95,350 from the exercise of warrants and stock options and payments of \$300,505 on borrowings. During the year ended December 31, 1997, the Company's line of credit and bank loans, other than the ESOP, were paid in full.

The Company is a guarantor of a \$500,000 term loan granted to the Company's employee stock ownership plan ("ESOP"). The balance outstanding of \$184,919 related to this term loan is included in the total amount of the Company's bank borrowings as of December 31, 1998, stated in the preceding paragraph. The loan is due in June 2001, and bears interest at 8.5% per annum. Proceeds from the loan were used to acquire the Company's common stock by the ESOP. Principal and interest on the loan will be paid by the ESOP through contributions made by the Company to the ESOP in the amount of approximately \$8,852 per month. This amount will be a monthly charge to expense.

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 upgraded its software at a cost of less than \$10,000 and has been informed by its suppliers that such software 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. The Company believes that all of its hardware is Year 2000 compliant. 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 new hardware and software to address the Year 2000 issue at a cost of approximately \$150,000 to make Gresham Power Year 2000 compliant. The Company anticipates that Gresham Power will complete the installation of 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.

The Company and its subsidiaries intend, but have not yet, 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. In the event that the Company receives indications from its suppliers and large customers that the Year 2000 Issue may materially effect their ability to conduct business, the Company will seek contingency plans such as finding other vendors that are Year 2000 compliant or increase its inventory of supplies or parts in an attempt to ensure smooth operations until such vendor can remedy the problem.

Impact of Recently Issued Standards

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 (FASB133), "Accounting for Derivative Instruments and Hedging Activities." This statement is effective for fiscal years beginning after June 15, 1999. Earlier application is encouraged; however, the Company does not anticipate adopting FASB133 until the fiscal year beginning January 1, 2000. FASB133 requires that an entity recognize all derivatives as assets or liabilities in the statement of financial position and measure those instruments at fair value. The Company does not believe the adoption of FASB133 will have a material impact on assets, liabilities or equity. The Company has not yet determined the impact of FASB133 on the income statement or the impact on comprehensive income.

FASB132, "Employers' Disclosures About Pensions and Other Postretirement Benefits" and FASB134, "Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise" were issued in 1998 and are not expected to impact the Company's future financial statement disclosures, results of operations and financial position.

Item 7. Financial Statements.

The financial statements of the Company, including the notes thereto and report of the independent auditors thereon, are attached hereto as exhibits as page numbers F-1 through F-26.

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

PART III**Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act of the Registrant.**

The information required by this item is incorporated by reference to the Company's definitive Proxy Statement for the annual meeting of stockholders under the captions "Election of Directors," "Further Information Concerning the Board of Directors," and "Section 16(a) Information." The Proxy Statement will be filed within 120 days of the Company's fiscal year end.

Item 10. Executive Compensation.

The information required by this item is incorporated by reference to the Company's definitive Proxy Statement for the annual meeting of stockholders under the caption "Executive Compensation." The Proxy Statement will be filed within 120 days of the Company's fiscal year end.

Item 11. Security Ownership of Certain Beneficial Owners and Management.

The information required by this item is incorporated by reference to the Company's definitive Proxy Statement for the annual meeting of stockholders under the caption "Principal Stockholders." The Proxy Statement will be filed within 120 days of the Company's fiscal year end.

Item 12. Certain Relationships and Related Transactions.

The information required by this item is incorporated by reference to the Company's definitive Proxy Statement for the annual meeting of stockholders under the caption "Certain Relationships and Related Transactions." The Proxy Statement will be filed within 120 days of the Company's fiscal year end.

Item 13. Exhibits and Reports on Form 8-K.

(a)	Exhibits
3.1	Amended and Restated Articles of Incorporation of Digital Power Corporation(1)
3.2	Amendment to Articles of Incorporation(1)
3.3	Bylaws of Digital Power Corporation(1)
4.1	Specimen Common Stock Certificate(2)
4.2	Specimen Warrant(1)
4.3	Representative's Warrant(1)
10.1	Revolving Credit Facility with San Jose National Bank(1)
10.2	KDK Contract(1)

10.3	Agreement with Fortron/Source Corp.(1)
10.4	Employment Agreement With Robert O. Smith(2)
10.5	1997 Stock Option Plan(1)
10.6	Gresham Power Asset Purchase Agreement(3)
10.7	1998 Stock Option Plan
10.8	Technology Transfer Agreement with KDK Electronics(4)
10.9	Loan Commitment and Letter Agreement

10.10 Promissory Note

21.1 List of Subsidiaries of Issuer

- (1) Previously filed with the Commission on October 16, 1996, to the Company's Registration Statement on Form SB-2.
- (2) Previously filed with the Commission on December 3, 1996, to the Company's Pre-Effective Amendment No. 1 to Registration Statement on Form SB-2.
- (3) Previously filed with the Commission on February 2, 1998, to the Company's Form 8-K.
- (4) Previously filed with the Commission with its Form 10-QSB for the quarter ended September 30, 1998.

(b) Reports on Form 8-K

None.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DIGITAL POWER CORPORATION, a California Corporation

/s/ Robert O. Smith

*Robert O. Smith,
Chief Executive Officer*

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signatures

Date

/s/ Robert O. Smith

April 12, 1999

*Robert O. Smith, Chief Executive Officer
(Principal Executive Officer)*

/s/ Philip G. Swany

April 12, 1999

*Philip G. Swany, Chief Financial Officer
(Principal Accounting and
Financial Officer)*

/s/ Robert J. Boschert

April 12, 1999

Robert J. Boschert, Director

/s/ Scott C. McDonald

April 10, 1999

Scott C. McDonald, Director

Thomas W. O'Neil, Jr., Director

April __, 1999

/s/ Chris Schofield

April 12, 1999

Chris Schofield, Director

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INDEPENDENT AUDITOR'S REPORT

To the Stockholders and Board of Directors Digital Power Corporation and Subsidiaries Fremont, California

We have audited the accompanying consolidated balance sheet of Digital Power Corporation and Subsidiaries as of December 31, 1998, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for the years ended December 31, 1998 and 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Digital Power Corporation and Subsidiaries as of December 31, 1998, and the results of their operations and their cash flows for the years ended December 31, 1998 and 1997, in conformity with generally accepted accounting principles.

/s/HEIN + ASSOCIATES LLP

HEIN + ASSOCIATES LLP
Certified Public Accountants

Orange, California
March 12, 1999

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

DECEMBER 31,
1998

ASSETS

CURRENT ASSETS:

Cash and cash equivalents	\$ 867,607
Accounts receivable - trade, net of allowance for doubtful accounts of \$292,000	3,560,038
Income tax refund receivable	392,646
Other receivables	103,042
Inventories, net	4,864,520
Prepaid expenses and deposits	55,264
Deferred income taxes	385,605

Total current assets	10,228,722
PROPERTY AND EQUIPMENT, net	1,402,233
EXCESS OF PURCHASE PRICE OVER NET ASSETS	
ACQUIRED, net of amortization of \$133,117	1,319,073
DEPOSITS	40,791

TOTAL ASSETS	\$ 12,990,819
	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Notes payable	\$ 2,206,846
Current portion of long-term debt	115,476
Current portion of capital lease obligations	63,131
Accounts payable	1,246,855
Accrued liabilities	1,595,098

Total current liabilities	5,227,406
LONG-TERM DEBT, less current portion	69,443
CAPITAL LEASE OBLIGATIONS, less current portion	114,156
OTHER LONG-TERM LIABILITIES	35,043
DEFERRED INCOME TAXES	26,000

Total liabilities	5,472,048

COMMITMENTS AND CONTINGENCIES (Notes 7, 9, 12, 13, and 14)	-
STOCKHOLDERS' EQUITY:	
Preferred stock issuable in series, no par value, 2,000,000 shares authorized, no shares issued and outstanding.	-
Common stock, no par value, 10,000,000 shares authorized, 2,771,435 shares issued and outstanding	9,012,679
Warrants	60,776
Additional paid-in capital	218,335
Accumulated deficit	(1,859,528)
Unearned employee stock ownership plan shares	(184,919)
Accumulated other comprehensive income	271,428

Total stockholders' equity	7,518,771

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 12,990,819
	=====

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	FOR THE YEARS ENDED DECEMBER 31,	
	1998	1997
REVENUES	\$ 18,733,470	\$ 18,884,259
COST OF GOODS SOLD	14,778,103	13,955,529
Gross margin	3,955,367	4,928,730
OPERATING EXPENSES:		
Engineering and product development	1,397,816	866,787
Marketing and selling	1,561,803	665,235
General and administrative	1,572,318	928,530
Total operating expenses	4,531,937	2,460,552
INCOME (LOSS) FROM OPERATIONS	(576,570)	2,468,178
OTHER INCOME (EXPENSE):		
Interest income	16,074	47,415
Interest expense	(236,968)	(68,957)
Translation loss	(37,771)	(19,846)
Gain on disposal of assets	6,647	-
Other income (expense)	(252,018)	(41,388)
INCOME (LOSS) BEFORE INCOME TAXES	(828,588)	2,426,790
INCOME TAX (BENEFIT) PROVISION	(258,000)	1,026,000
NET INCOME (LOSS)	\$ (570,588)	\$ 1,400,790
NET INCOME (LOSS) PER COMMON SHARE:		
Basic	\$ (.21)	\$.54
Diluted	\$ (.21)	\$.41

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) FOR THE YEARS ENDED DECEMBER 31, 1998 and 1997

	FOR THE YEARS ENDED DECEMBER 31,	
	1998	1997
NET INCOME (LOSS)	\$ (570,588)	\$ 1,400,790
OTHER COMPREHENSIVE INCOME ITEMS, before tax		
Foreign currency translation adjustments	36,234	-
Additional compensation expense for income tax purposes related to the exercise of stock options	79,869	397,506
COMPREHENSIVE INCOME (LOSS), before tax	(454,485)	1,798,296
INCOME TAX EXPENSE RELATED TO ITEMS OF COMPREHENSIVE INCOME	(41,503)	(200,678)
COMPREHENSIVE INCOME (LOSS), net of tax	\$ (495,988)	\$ 1,597,618
	=====	=====

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 1998 and 1997

	COMMON STOCK						ACCUMULATED OTHER	TOTAL
	SHARES	AMOUNT	WARRANTS	PAID-IN CAPITAL	ACCUMULATED DEFICIT	ESOP SHARES	COMPREHENSIVE INCOME	STOCK- HOLDERS' EQUITY
BALANCES, January 1, 1997	2,363,275	\$ 7,630,246	\$ 66,875	\$ 136,399	\$ (2,689,730)	\$ (461,128)	\$ -	\$4,682,662
Sale of common stock and warrants, net of expenses	150,000	484,122	8,256	-	-	-	-	492,378
Exercise of stock options	55,500	99,900	-	-	-	-	-	99,900
Exercise of warrants	125,710	642,221	(13,671)	-	-	-	-	628,550
Contribution to the ESOP	-	-	-	-	-	135,705	-	135,705
Compensation recognized upon issuance of warrants	-	-	-	35,903	-	-	-	35,903
Income tax benefit arising from the exercise of employee stock options	-	-	-	-	-	-	196,828	196,828
Net income	-	-	-	-	1,400,790	-	-	1,400,790
BALANCES, December 31, 1997	2,694,485	8,856,489	61,460	172,302	(1,288,940)	(325,423)	196,828	7,672,716
Exercise of stock options	35,750	64,350	-	-	-	-	-	64,350
Exercise of warrants	6,200	31,684	(684)	-	-	-	-	31,000
Stock issued for legal settlement	35,000	60,156	-	-	-	-	-	60,156
Contribution to the ESOP	-	-	-	-	-	140,504	-	140,504
Compensation recognized upon issuance of warrants	-	-	-	46,033	-	-	-	46,033
Income tax benefit arising from the exercise of employee stock options	-	-	-	-	-	-	38,366	38,366
Foreign currency translation adjustment	-	-	-	-	-	-	36,234	36,234
Net loss	-	-	-	-	(570,588)	-	-	(570,588)
BALANCES, December 31, 1998	2,771,435	\$ 9,012,679	\$ 60,776	\$ 218,335	\$ (1,859,528)	\$ (184,919)	\$271,428	\$7,518,771

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	FOR THE YEARS ENDED DECEMBER 31,	
	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ (570,588)	\$ 1,400,790
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	423,655	174,047
Gain on disposal of assets	(6,647)	(18,678)
Deferred income taxes	(287,927)	-
Warranty expense	140,000	30,000
Inventory reserve	230,000	(100,000)
Contribution to ESOP	140,504	135,705
Bad debt expense	50,000	65,000
Compensation cost recognized upon issuance of warrants	46,033	35,903
Income tax	38,366	196,828
Foreign currency translation adjustment	37,771	19,846
Stock issued for legal settlement	60,156	-
Changes in operating assets and liabilities:		
Accounts receivable	614,453	(601,480)
Income tax refund receivable	(392,646)	-
Other receivables	173,507	(43,310)
Inventories	434,597	(1,036,860)
Prepaid expenses	73,986	(100,515)
Other assets	(23,531)	168
Accounts payable	(1,950,562)	281,916
Accrued liabilities	743,896	(519,612)
Other long-term liabilities	35,043	-
Net cash provided by (used in) operating activities	10,066	(80,252)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of Gresham Power Electronics	(3,370,293)	-
Purchase of property and equipment	(156,707)	(388,825)
Proceeds from sale of assets	26,414	-
Net cash used in investing activities	(3,500,586)	(388,825)

(continued)

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Continued)

	FOR THE YEARS ENDED DECEMBER 31,	
	1998	1997
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock and warrants	\$ -	\$ 492,378
Proceeds from exercise of stock options and warrants	95,350	728,450
Principal payments on long-term debt	(140,504)	(271,185)
Principal payments on capital lease obligations	(7,310)	(13,406)
Proceeds from notes payable	2,366,846	1,990,964
Principal payments on notes payable	(160,000)	(3,188,294)
Net cash provided by (used in) financing activities	2,154,382	(261,093)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(1,537)	(19,846)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,337,675)	(750,016)
CASH AND CASH EQUIVALENTS, beginning of period	2,205,282	2,955,298
CASH AND CASH EQUIVALENTS, end of period	\$ 867,607	\$ 2,205,282
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash payments for:		
Interest	\$ 233,982	\$ 74,874
Income taxes	\$ 289,872	\$ 1,017,402
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Acquisition of equipment through capital leases	\$ 166,396	\$ -

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND NATURE OF OPERATIONS:

Digital Power Corporation ("DPC"), and one of its wholly owned subsidiaries Poder Digital, S.A. de C.V. ("PD"), which is located in Guadalajara, Mexico, are engaged in the design, manufacture and sale of switching power supplies.

On January 26, 1998, DPC acquired the assets and assumed certain liabilities of Gresham Power Electronics, a division of Gresham Lion Technology Ltd., a European corporation, through a newly-formed subsidiary Digital Power Limited ("DPL"). (See Note 3.) DPL is also engaged in the design, manufacture, and sale of switching power supplies.

DPC, PD, and DPL are collectively referred to as the "Company".

2. SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation - The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Statements of Cash Flows - For purposes of the statements of cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Inventories - Inventories are stated at the lower of cost (first-in, first-out) or market.

Property and Equipment - Property and equipment are stated at cost. Depreciation of equipment and furniture is calculated using the straight-line method over the estimated useful lives (ranging from 5 to 10 years) of the respective assets. Leasehold improvements are amortized over the shorter of their estimated useful life or the term of the lease. The cost of normal maintenance and repairs is charged to operations as incurred. Material expenditures which increase the life of an asset are capitalized and depreciated over the estimated remaining useful life of the asset. The cost of fixed assets sold, or otherwise disposed of, and the related accumulated depreciation or amortization are removed from the accounts, and any resulting gains or losses are reflected in current operations.

Excess of Purchase Price Over Net Assets Acquired - Excess of purchase price over net assets acquired ("Goodwill") represents the purchase price in excess of the fair value of the net assets of the acquired business and is being amortized using the straight-line method over its estimated useful life of ten years. The carrying value is evaluated at least annually. The Company considers current facts and circumstances, including expected future operating income and cash flows to determine whether it is probable that impairment has occurred.

Income Taxes - The Company accounts for income taxes under the liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Revenue Recognition - Sales revenue is recognized when the products are shipped to customers, including distributors. Customers receive a one or two-year product warranty and certain sales to distributors are subject to a limited right of return. The Company provides a reserve for estimated warranty costs and a reserve for estimated product returns.

Foreign Currency Translation - Assets and liabilities of the Company's foreign subsidiaries are translated into U.S. dollars at year-end exchange rates. Income and expense items are translated at average exchange rates prevailing during the year. The resulting translation adjustment for DPL is recorded as accumulated other comprehensive income, a component of stockholders equity. Because PD operates in a country with a highly inflationary economy, any translation adjustment is included in the results of operations.

Earnings Per Share - Basic earnings per share excludes dilution and is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Common stock equivalents for the year ending December 31, 1998 were anti-dilutive and excluded in the earnings per share computation.

Accounting Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. The actual results could differ from those estimates.

The Company's financial statements are based upon a number of significant estimates including the allowance for doubtful accounts, technological obsolescence of inventories, the estimated useful lives selected for property and equipment and goodwill, realizability of deferred tax assets, allowance for sales returns, and warranty reserve. Due to the uncertainties inherent in the estimation process, it is at least reasonably possible that these estimates will be further revised in the near term and such revisions could be material.

Impairment of Long-Lived Assets - In the event that facts and circumstances indicate that the cost of long-lived assets may be impaired, an evaluation of recoverability would be performed. If an evaluation is required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down to market value or discounted cash flow value is required.

Stock-Based Compensation - The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB25) and related interpretations in accounting for its employee stock options. In accordance with FASB Statement No. 123 "Accounting For Stock-Based Compensation" (FASB123), the Company will disclose the impact of adopting the fair value accounting of employee stock options. Transactions in equity instruments with non-employees for goods or services have been accounted for using the fair value method prescribed by FASB123.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Concentrations of Credit Risk - Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on or off balance sheet) that arise from financial instruments exist for groups of customers or groups of counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly effected by changes in economic or other conditions. In accordance with FASB Statement No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk," the credit risk amounts shown, in Note 13, do not take into account the value of any collateral or security.

Fair Value of Financial Instruments - The estimated fair values for financial instruments under FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments," are determined at discrete points in time based on relevant market information. These estimates involve uncertainties and cannot be determined with precision.

The following methods and assumptions were used in estimating the indicated fair values of the Company's financial instruments:

Cash and cash equivalents: The carrying amount approximates fair value because of the short maturity of those instruments.

Long-term and other debt: The fair value of the Company's debt is estimated based on current rates offered to the Company for similar debt and approximates carrying value.

Comprehensive Income - The Company has adopted the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (FASB130). FASB130 defines comprehensive income as all changes in stockholders' equity exclusive of transactions with owners, such as capital investments. Comprehensive income includes net income or loss and changes in certain assets and liabilities that are reported directly in equity, such as, translation adjustments on investments in foreign subsidiaries, difference in the recognition of compensation expense for books versus tax for employee stock options, and certain changes in minimum pension liabilities.

Impact of Recently Issued Standards - In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 (FASB133), "Accounting for Derivative Instruments and Hedging Activities". This statement is effective for fiscal years beginning after June 15, 1999. Earlier application is encouraged; however, the Company does not anticipate adopting FASB133 until the fiscal year beginning January 1, 2000. FASB133 requires that an entity recognize all derivatives as assets or liabilities in the statement of financial position and measure those instruments at fair value. The Company does not believe the adoption of FASB133 will have a material impact on assets, liabilities or equity. The Company has not yet determined the impact of FASB133 on the income statement or the impact on comprehensive income.

FASB132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" and FASB134, "Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise" were issued in 1998 and are not expected to impact the Company's future financial statement disclosures, results of operations and financial position.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Reclassifications - Certain reclassifications have been made to the prior year's consolidated financial statements to conform with the current presentation. Such reclassifications had no effect on net income (loss).

3. ACQUISITION:

In January 1998, the Company entered into an agreement to acquire certain assets and assume certain liabilities of Gresham Power Electronics, a division of Gresham Lion Technology Ltd., a European Corporation. The total purchase price including acquisition costs was \$3,370,293 with \$1,452,190 being allocated to excess of purchase price over net assets acquired.

Gresham Power Electronics had no material activity for 1998 prior to the acquisition, therefore the statements presented for the year ended December 31, 1998 resemble those that would be shown in a pro forma. The following presents unaudited pro forma information as if the acquisitions described above occurred on January 1, 1997:

FOR THE YEAR ENDED DECEMBER 31, 1997

Revenue	\$ 21,895,259
	=====
Operating income (loss)	\$ 2,530,178
	=====
Net income (loss)	\$ 1,393,790
	=====
Basic income per common share	\$.54
	=====
Diluted income per common share	\$.41
	=====

4. INVENTORY:

Inventory consists of the following as of December 31, 1998:

Raw materials	\$ 4,448,871
Work-in-process	829,967
Finished goods	232,182

	5,511,020
Allowance for obsolescence	(646,500)

	\$ 4,864,520
	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. PROPERTY AND EQUIPMENT:

Property and equipment consist of the following as of December 31, 1998:

Machinery and equipment	\$	1,338,278
Office equipment and furniture		752,934
Leasehold improvements		500,341
Transportation equipment		117,093

		2,708,646
Accumulated depreciation and amortization		(1,306,413)

	\$	1,402,233
		=====

6. ACCRUED LIABILITIES:

Accrued liabilities consist of the following as of December 31, 1998:

Accrued payroll and benefits	\$	430,314
Accrued commissions and royalties		243,894
Accrued warranty and product return expense		383,291
Income taxes payable		163,884
Other		373,715

	\$	1,595,098
		=====

7. NOTES PAYABLE:

Notes payable consist of the following at December 31, 1998:

Revolving line of credit agreement with a financial institution. Interest payable monthly at the bank's prime rate, 7.75% at December 31, 1998.
\$ 1,590,000

Advances under factoring agreement	616,846

	\$ 2,206,846
	=====

The revolving line of credit agreement provides for borrowings up to 80% of eligible accounts receivable, plus 20% of inventory or \$500,000, whichever is less, not to exceed a total of \$3,000,000. Under the terms of the agreement, the Company is required to maintain certain ratios and be in compliance with other covenants. At December 31, 1998, the Company was not in compliance with certain covenants. Subsequent to December 31, 1998, the Company received a waiver from the financial institution with regards to those items.

In February 1998, DPL entered into an agreement to factor its accounts receivable at a discount of 0.195% plus interest at the rate of 2% above Lloyds Bank Base Rate per annum (8.25% at December 31, 1998). The factor may maintain a reserve of 25% of the outstanding balance on accounts factored. As of December 31, 1998, the face amount of accounts factored was \$822,461.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

8. LONG-TERM DEBT:

As of December 31, 1998, long-term debt consisted of an Employee Stock Ownership Plan loan, for which the current portion equaled \$115,476 and the long-term portion equaled \$69,443. See Note 14 for details.

Aggregate maturities of long-term debt are due as follows:

YEARS ENDING DECEMBER 31, -----	AMOUNT -----
1999	\$ 115,476
2000	69,443

	\$ 184,919
	=====

9. CAPITAL LEASE OBLIGATIONS:

The Company leases certain equipment and vehicles under agreements classified as capital leases. The cost of these assets related to the leases is \$224,557 and accumulated depreciation amounts to \$86,662 at December 31, 1998.

The future minimum lease payments are as follows:

YEARS ENDING DECEMBER 31, -----	AMOUNT -----
1999	\$ 68,327
2000	46,631
2001	34,785
2002	26,798
2003	13,398

Total future minimum lease payments	189,939
Less amount representing interest	(12,652)

Present value of net minimum lease payments	177,287
Less Current portion	(63,131)

	\$ 114,156
	=====

10. STOCKHOLDERS' EQUITY:

COMMON STOCK

In December 1996, the Company completed a public offering of 750,000 shares of its common stock along with 500,000 warrants, at a public offering price of \$4.00 per share and \$.125 per warrant.

As part of the public offering, the underwriter was allocated an additional 150,000 shares at \$4.00 per share and 75,000 warrants at \$.125 per warrant to cover over-allotments, if any. On January 8, 1997, the underwriter exercised and sold the over allotment shares and warrants for net proceeds of \$492,378.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

PREFERRED STOCK

The preferred stock has one series authorized, 500,000 shares of Series A cumulative redeemable convertible preferred stock ("Series A"), and an additional 1,500,000 shares of preferred stock has been authorized, but the rights, preferences, privileges and restrictions on these shares has not been determined. DPC's Board of Directors is authorized to create new series of preferred stock and fix the number of shares as well as the rights, preferences, privileges and restrictions granted to or imposed upon any series of preferred stock.

STOCK OPTIONS

The Company has issued non-qualified options covering 104,922 shares exercisable at \$.50 per share. Upon issuance, the Company recorded compensation expense for the difference between the exercise price and the fair market value of the underlying common stock of \$1.80 per share. Such options expire in 2003. At December 31, 1998, 86,900 of such options were outstanding.

In May 1993, the Company issued options to purchase 237,500 shares of its common stock at \$1.80 per share. Such options are subject to a four-year vesting plan. The exercise price of \$1.80 per share approximated the fair market value at the date of grant. During the years ended December 31, 1998 and 1997, 12,500 and 55,500, respectively, of such options were exercised. 167,000 of these options are outstanding at December 31, 1998. During the year ended December 31, 1997, 2,500 of such options were forfeited.

In May 1996, the Company adopted the 1996 Stock Option Plan covering 513,000 shares. Under the plan, the Company can issue either incentive or non-statutory stock options. The price of the options granted pursuant to the plan will not be less than 100% of the fair market value of the shares on the date of grant. The board of directors will decide the vesting period of the options, if any, and no option will be exercisable after ten years from the date granted. Immediately thereafter, the Company issued options to purchase 275,500 shares of its common stock at \$1.80 per share. Such options become 100% vested two years after issuance. The exercise price was based upon their terms, conditions and restrictions. During the years ended December 31, 1998 and 1997, 1,000 and 19,000 of such options were forfeited. During the year ended December 31, 1998, 23,250 of such options were exercised.

On January 2, 1997, the Company granted 100,000 options to purchase the Company's stock to the president of the Company, in accordance with his employment agreement. The exercise price of \$5.4375 per share was equal to the fair market value on the date of grant. These options were repriced in November 1998 to the fair market value of \$2.3125.

On February 4, 1997, the Company granted 28,000 options with an exercise price of \$6.625 per share, which was equal to the fair market value on the date of grant, to certain employees to purchase the Company's stock. The options vest over 5 years. The options were repriced in November 1998 to the fair market value of \$2.3125. During the years ended December 31, 1998 and 1997, 4,000 and 8,000, respectively, of such options were forfeited.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On November 4, 1997, the Company granted 10,000 options with an exercise price of \$7.125 per share, which was equal to the fair market value on the date of grant, to an employee, to purchase the Company's stock. The options vest over 4 years at 25% per year. During the year ended December 31, 1998, all 10,000 of the options were forfeited.

On January 2, 1998, the Company granted 100,000 options to purchase the Company's stock to the president of the Company, in accordance with his employment agreement. The exercise price of \$6.6875 per share was equal to the fair market value on the date of grant. On November 5, 1998, these options were repriced to \$2.3125, which was equal to the fair market value on that date.

On January 12, 1998, the Company granted 229,000 options to purchase the Company's stock under the 1996 Stock Option Plan to certain employees. The exercise price was \$6.1250, which was equal to the fair market value on the date of grant. The options vest over 5 years at 25% per year starting in the second year. On November 5, 1998, the options were repriced to the current fair market value of \$2.3125 per share. During the year, 76,400 options were forfeited.

During the year ended December 31, 1998, the Company granted 60,000 options to purchase the Company's stock to its three outside directors. The exercise price ranged from \$6.00 to \$6.25 per share, which was equal to the fair value on the date of grant. The options vest after one year.

In February 1998, the Company adopted the 1998 Stock Option Plan covering 240,000 shares. Under the plan, the Company can issue either incentive or non-qualified stock options. The exercise price of the options granted pursuant to the plan will not be less than 100% of the fair market value of the shares on the grant date. The vesting period of the options will be determined by the compensation committee of the Board of Directors, if any, and no options will be exercisable after ten years from the date of grant. Immediately thereafter, the Company granted 124,940 options to purchase the Company's stock to the employees of DPL at an exercise price of \$6.25. The options vest over 5 years at 25% per year starting in the second year. On November 5, 1998, the options were repriced to the current fair market value of \$2.3125 per share. As of December 31, 1998, 7,760 options had been forfeited.

In July 1998, the Company granted 25,000 options to purchase stock to an employee under the 1998 Stock Option Plan. The exercise price was \$4.00 per share, which equaled the market price on the date of grant. The options vest over 5 years at 25% per year starting in the second year. On November 5, 1998, the options were repriced to the current fair market value of \$2.3125 per share.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table sets forth activity for all options:

	NUMBER	AVERAGE EXERCISE PRICE PER SHARE
	-----	-----
OUTSTANDING, January 1, 1997	597,400	\$.50 - \$1.80
Granted	138,000	5.80
Forfeited	(27,000)	3.23
Exercised	(55,500)	1.80
	-----	-----
BALANCE, December 31, 1997	652,900	2.41
Granted	538,940	2.74
Forfeited	(99,160)	2.79
Exercised	(35,750)	1.80
	-----	-----
BALANCE, December 31, 1998	1,056,930	\$ 2.19
	=====	=====

At December 31, 1998 options to purchase 690,150 shares, were exercisable at prices ranging from \$.50 to \$1.80 per share. The remaining 366,780 shares become exercisable as follows:

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
-----	-----	-----
1999	60,000	\$ 6.13
2000	77,695	2.31
2001	77,695	2.31
2002	77,695	2.31
2003	73,695	2.31
	-----	-----
	366,780	\$ 2.94
	=====	=====

If not previously exercised the outstanding options will expire as follows:

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
-----	-----	-----
2003	253,900	\$ 1.36
2004	-	-
2005	-	-
2006	232,250	1.80
2007	116,000	2.31
2008	454,780	2.82
	-----	-----
	1,056,930	\$ 2.19
	=====	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

WARRANTS

The following represents all activity that took place with regards to warrants issued:

	NUMBER	AVERAGE EXERCISE PRICE PER SHARE
	-----	-----
OUTSTANDING, January 1, 1997	850,000	\$ 4.99
Sold	75,000	5.00
Granted	15,000	6.75
Exercised	(125,710)	5.00
	-----	-----
BALANCE, December 31, 1997	814,290	5.02
Granted	30,000	7.00
Exercised	(6,200)	5.00
	-----	-----
BALANCE, December 31, 1998	838,090	\$ 5.09
	=====	=====

Compensation cost related to the warrants granted for outside services amounted to \$46,033 and \$35,903 for the years ended December 31, 1998 and 1997, respectively. The warrants expire three years after the grant date.

PROFORMA INFORMATION

As stated in Note 2, the Company has not adopted the fair value accounting prescribed by FASB123 for employees. Had compensation cost for stock options or warrants issued to employees been determined based on the fair value at grant date for awards in 1998 and 1997, consistent with the provisions of FASB123, the Company's net income (loss) and net income (loss) per share would have been reduced to the proforma amounts indicated below:

	1998	1997
	-----	-----
Net income (loss)	\$ (1,472,924)	\$ 1,159,540
	=====	=====
Net income (loss) per common share:		
Basic	\$ (.59)	\$.45
	=====	=====
Diluted	\$ (.59)	\$.34
	=====	=====

The fair value of each option or warrant is estimated on the date of grant using the present value of the exercise price and is pro-rated based on the percent of time from the grant date to the end of the vesting period. The weighted-average fair value of the options on the grant date was \$2.74 and \$5.80 per share for 1998 and 1997, respectively. The following assumptions were used for grants in 1998 and 1997: average risk-free interest rates of 5.6% and 5.8%, respectively; expected lives of five years and two years, respectively; dividend yield of 0%; and expected volatility of 69.3% and 56.8%, respectively.

11. NET INCOME (LOSS) PER COMMON SHARE:

The following represents the calculation of net income (loss) per common share:

FOR THE YEARS ENDED

	1998	1997
	-----	-----
BASIC		
Net income (loss)	\$ (570,588)	\$ 1,400,790
Less - preferred stock dividends	-	-
	-----	-----
Net income (loss) applicable to common shareholders	\$ (570,588)	\$ 1,400,790
	=====	=====
Weighted average number of common shares	2,726,631	2,577,889
	=====	=====
Basic earnings (loss) per share	\$ (.21)	\$.54
	=====	=====
DILUTED		
Net income (loss) available to common shareholders	\$ (570,588)	\$ 1,400,790
Preferred stock dividend	-	-
	-----	-----
Net income (loss) available to common shareholders plus assumed conversion	\$ (570,588)	\$ 1,400,790
	=====	=====
Weighted average number of common shares	2,726,631	2,577,889
Common stock equivalent shares representing shares issuable upon exercise of stock options	-	487,237
Common stock equivalent shares representing shares issuable upon exercise of warrants	-	355,252
	-----	-----
Weighted average number of shares used in calculation of diluted income (loss) per share	2,726,631	3,420,378
	=====	=====
Diluted earnings (loss) per share	\$ (.21)	\$.41
	=====	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. COMMITMENTS:

LEASES

The Company leases its office space in California, a manufacturing facility in Guadalajara, Mexico, and the facility and certain equipment in the UK under operating leases. The total future minimum lease payments are as follows:

YEARS ENDING DECEMBER 31,

1999	\$	249,964
2000		243,602
2001		137,316
2002		121,724
2003		116,270
Thereafter		667,063

	\$	1,535,939
		=====

Lease payments on the manufacturing facility in Mexico are to be made in Mexican Pesos. Lease payments on the facility and equipment in the UK are to be made in GB pound-sterling. The above schedule was prepared using the conversion rate in effect at December 31, 1998. Changes in the conversion rate will have an impact on the Company's required minimum payments and its operating results.

Rent expense was \$243,154 and \$117,341 for 1998 and 1997, respectively.

ROYALTY AGREEMENT

The Company had a royalty agreement with a third party on various products, and any derivatives from the base design of these products.

In April 1998, the third party filed a lawsuit against the Company related to this agreement. This lawsuit was settled in September 1998. In exchange for the release of all future obligations under the royalty agreement, the Company agreed to pay \$150,000 and issue 35,000 shares of common stock. The shares were issued upon the close of the agreement. The \$150,000 is due in installments through June 2000. As of December 31, 1998, the Company had paid \$34,000 in installments, the remaining \$116,000 is included in accrued liabilities.

EMPLOYMENT AGREEMENT

The Company has an employment contract with its President/CEO which terminates on December 31, 1999. Under the terms of the employment contract, he shall serve as president and chief executive officer of the Company and his salary shall be \$150,000 per annum effective January 1, 1997, increasing in an amount to be determined by the employee and the Board such that he shall receive \$200,000 per annum by January 1, 1999. In addition, pursuant to the contract, he shall have the right to receive on the first business day of each January during the term of his contract options to acquire 100,000 shares of Common Stock at the lower of market value per share as of such date or the average per share bid price for the first six months beginning from the date of grant of this option. Finally, pursuant to the employment contract, in the event there is a change in control of the Company, the employee shall be granted a five year consulting contract at \$200,000 per year.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. SIGNIFICANT CONCENTRATIONS OF CREDIT RISK, MAJOR CUSTOMERS AND OTHER RISKS AND UNCERTAINTIES:

Sales to unaffiliated customers of the Company's DPC segment represented more than 10% of the Company's net sales for 1998 and 1997 and were as follows (customers A & D are distributors):

CUSTOMER	1998	1997
-----	----	----
A	13%	25%
B	8%	14%
C	-	24%
D	10%	5%

The Company operates primarily in one industry: the manufacture and sale of switching power supplies. Financial instruments that subject the Company to credit risk consist primarily of accounts receivable. The Company frequently sells large quantities of inventory to its customers. At December 31, 1998, approximately \$2,171,560 or 56% of the Company's net accounts receivable were due from ten customers.

As of December 31, 1998, the Company maintained cash in banks that was approximately \$666,208 in excess of the federally insured limit.

14. EMPLOYEE BENEFIT PLANS:

401(K) PROFIT SHARING PLAN

The Company has a 401(k) profit sharing plan (the "Plan") covering substantially all employees of DPC. Eligible employees may make voluntary contributions to the Plan, which are matched by the Company at a rate of \$.25 for each \$1.00 contributed, up to a maximum of six percent of eligible compensation. The Company can also make discretionary contributions. The Company made matching contributions to the Plan of \$17,073 and \$19,625 for 1998 and 1997, respectively. The Board of Directors of DPC elected not to make a discretionary contribution to the Plan for 1998 or 1997.

The Company's subsidiary DPL, has a group personal pension plan covering substantially all of its employees. Eligible employees may make voluntary contributions to the plan. The Company will contribute 7% of the employees basic annual salary to the plan. Contributions are charged to operations as incurred. The Company made contributions totaling \$50,145 to the plan for the year ended December 31, 1998.

EMPLOYEE STOCK OWNERSHIP PLAN

The Company also has an employee stock ownership plan (the "ESOP") covering substantially all employees of DPC. The Company can make discretionary contributions of cash or company stock (as defined in the ESOP plan document) up to deductible limits prescribed by the Internal Revenue Code.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Effective June 13, 1996, the ESOP obtained a \$500,000 loan guaranteed by the Company for the purpose of acquiring common stock of the Company from existing stockholders. The loan bears interest at 8.5% per annum and requires monthly payments of principal and interest of \$8,852 through June 2001. The balance at December 31, 1998 was \$184,919. Immediately upon the funding of the loan, the ESOP purchased approximately 154,000 shares of the Company's common stock from existing shareholders. The Company is required to contribute amounts to the plan to sufficiently cover the debt payments. Contributions to the plan in 1998 and 1997 were \$165,971 and \$179,416, respectively.

In accordance with the AICPA Statements of Position 93-6 entitled "Employers Accounting for Employee Stock Ownership Plans", the Company has recorded the loan as debt on its books with a corresponding charge to stockholders' equity.

15. INCOME TAXES:

Income tax expense (benefit) is comprised of the following:

FOR THE YEARS ENDED

	1998	1997
	-----	-----
Current		
Federal	\$ (32,135)	\$ 808,978
State	(59,543)	235,700
Foreign	121,000	-
	-----	-----
	29,322	1,044,678
	-----	-----
Deferred		
Federal	(233,865)	(15,135)
State	(53,457)	(3,543)
Foreign	-	-
	-----	-----
	(287,322)	(18,678)
	-----	-----
	\$ (258,000)	\$ 1,026,000
	=====	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The components of the net deferred tax asset and liability recognized as of December 31, 1998 are as follows:

Current deferred tax assets (liabilities):

Accounts receivable, principally due to allowance for doubtful accounts	114,393
Compensated absences, principally due to accrual for financial reporting purposes	36,049
Accrued commissions	22,520
Inventory reserve	192,662
Warranty reserve	122,421
Stock rotation liability	24,083
Accrued settlement	60,749
Accrued other	31,458
Book compensation for stock options	79,034
Effect of change in account method	(219,186)
UNICAP	23,895
State taxes	(11,550)

	476,528
Valuation allowance	(90,923)

Net current deferred tax asset	\$ 385,605
	=====
Long-term deferred tax assets (liabilities):	
Net operating loss carryforwards	\$ 6,002
Depreciation	(32,002)

Net long-term deferred tax liability	\$ (26,000)
	=====

Total income tax expense differed from the amounts computed by applying the U.S. federal statutory tax rates to pre-tax income as follows:

FOR THE YEARS ENDED

	1998	1997
	-----	-----
Total expense (benefit) computed by applying the U.S. statutory rate	(34.0%)	34.0%
Permanent differences	.8	.2
State income taxes	(13.5)	8.0
Tax effect resulting from foreign activities	7.4	(.4)
Change in valuation allowance	10.8	-
Change in beginning balance of deferred asset	(8.2)	-
Effect of IRS examination	5.4	-
Other	.6	.5
	-----	-----
	(30.7%)	42.3%
	=====	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. ACCUMULATED OTHER COMPREHENSIVE INCOME BALANCES:

Accumulated other comprehensive income consists of the following as of December 31, 1998:

	Foreign Currency Items	Compensation related to exercise of stock option	Accumulated Other Comprehensive Income
	-----	-----	-----
Beginning Balance	\$ -	\$ 196,828	\$ 196,828
Current-period change	36,234	38,366	74,600
	-----	-----	-----
	\$ 36,234	\$ 235,194	\$ 271,428
	=====	=====	=====

17. FOURTH QUARTER ADJUSTMENTS AND TRANSACTIONS:

During the fourth quarter of 1998, the Company recognized certain expenses as follows:

Additional allowance for inventory obsolescence	\$ 260,000
Additional allowance for doubtful accounts	85,000
Additional accrual for warranty expense	140,000
Additional accruals for litigation settlements	222,166
Accruals for severance payments	51,746

Total	\$ 758,912
	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

18. SEGMENT REPORTING:

The Company has identified its segments based upon its geographic operations. These segments are represented by each of the Company's individual legal entities: DPC, PD and DPL. Segment information is as follows:

	1998				
	DPC	PD	DPL	Eliminations	Totals
	-----	-----	-----	-----	-----
Revenues	\$ 11,681,979	\$ 49,450	\$ 7,002,041	\$ -	\$ 18,733,470
	=====	=====	=====	=====	=====
Intersegment Revenues	\$ 94,223	\$ 2,541,720	\$ -	\$ (2,635,943)	\$ -
	=====	=====	=====	=====	=====
Interest Income	\$ 114,686	\$ -	\$ -	\$ (98,612)	\$ 16,074
	=====	=====	=====	=====	=====
Interest Expense	\$ 163,344	\$ 3,867	\$ 168,369	\$ (98,612)	\$ 236,968
	=====	=====	=====	=====	=====
Depreciation and Amortization	\$ 164,548	\$ 26,780	\$ 232,327	\$ -	\$ 423,655
	=====	=====	=====	=====	=====
Income Tax Expense (Benefit)	\$ (378,983)	\$ -	\$ 120,983	\$ -	\$ (258,000)
	=====	=====	=====	=====	=====
Net Income (loss)	\$ (634,896)	\$ (52,312)	\$ 116,620	\$ -	\$ (570,588)
	=====	=====	=====	=====	=====
Segment Assets	\$ 10,999,046	\$ 602,425	\$ 5,501,699	\$ (4,112,351)	\$ 12,990,819
	=====	=====	=====	=====	=====
Expenditures for Segment Assets	\$ 34,182	\$ 76,185	\$ 212,736	\$ -	\$ 323,103
	=====	=====	=====	=====	=====

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	1997				
	DPC	PD	DPL	Eliminations	Totals
	-----	-----	-----	-----	-----
Revenues	\$ 18,846,381	\$ 37,878	\$ -	\$ -	\$ 18,884,259
	=====	=====	=====	=====	=====
Intersegment Revenues	\$ -	\$ 2,891,664	\$ -	\$ (2,891,664)	\$ -
	=====	=====	=====	=====	=====
Interest Income	\$ 47,415	\$ -	\$ -	\$ -	\$ 47,415
	=====	=====	=====	=====	=====
Interest Expense	\$ 61,892	\$ 7,065	\$ -	\$ -	\$ 68,957
	=====	=====	=====	=====	=====
Depreciation and Amortization	\$ 145,237	\$ 28,810	\$ -	\$ -	\$ 174,047
	=====	=====	=====	=====	=====
Income Tax Expense	\$ 1,026,000	\$ -	\$ -	\$ -	\$ 1,026,000
	=====	=====	=====	=====	=====
Net Income	\$ 1,373,473	\$ 27,317	\$ -	\$ -	\$ 1,400,790
	=====	=====	=====	=====	=====
Segment Assets	\$ 10,363,939	\$ 551,466	\$ -	\$ (452,951)	\$ 10,462,454
	=====	=====	=====	=====	=====
Expenditures for Segment Assets	\$ 274,075	\$ 114,750	\$ -	\$ -	\$ 388,825
	=====	=====	=====	=====	=====

Exhibit 10.7

**DIGITAL POWER CORPORATION
1998 STOCK OPTION PLAN**

1. PURPOSE; DEFINITIONS.

1.1 Purpose. The purpose of the Plan is to attract, retain, and motivate officers, employees, consultants, and directors of the Company by giving them the opportunity to acquire Stock ownership in the Company.

1.2 Definitions. For purposes of the Plan, the following terms shall have the following meanings:

1.2.1 "Administrator" shall mean the Compensation Committee referred to in Section 4 in its capacity as administrator of the Plan in accordance with Section 4.

1.2.2 "Board" shall mean the Board of Directors of the Company.

1.2.3 "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time.

1.2.4 "Company" shall mean Digital Power Corporation, a California corporation, or its subsidiary.

1.2.5 "Director" shall mean a member of the Board.

1.2.6 "Effective Date" shall have the meaning set forth in Section 2.

1.2.7 "Eligible Person" shall mean, in the case of the grant of an Incentive Stock Option, all employees of the Company, and in the case of a Non-qualified Stock Option, any director (including a director who is also a member of the Compensation Committee), officer, or employee of or consultant to the Company.

1.2.8 "Fair Market Value" shall mean the value established by the Administrator for purposes of granting Options under the Plan.

1.2.9 "Grant Date" shall mean the date of grant of any Option.

1.2.10 "Incentive Stock Option" shall mean an Option within the meaning of Section 422 of the Code, the award of which contains such provisions as are necessary to comply with that section.

1.2.11 "Non-qualified Stock Option" shall mean an Option which is designated a Nonqualified Stock Option.

1.2.12 "Option" shall mean an option to purchase Common Stock under this Plan. An Option shall be designated by the Committee as either an Incentive Stock Option or a Non-qualified Stock Option.

1.2.13 "Option Agreement" shall mean the written option agreement with respect to an Option.

1.2.14 "Optionee" shall mean the holder of an Option.

1.2.15 "Plan" shall mean this Digital Power Corporation 1998 Stock Option Plan, as amended from time to time.

1.2.16 "Stock" shall mean the Common Stock, no par value, of the Company, and any successor entity.

1.2.17 "Vesting Date" shall mean the date on which an Option becomes wholly or partially exercisable, as determined by the Administrator in its sole discretion.

2. EFFECTIVE DATE; TERM OF PLAN.

The Effective Date of this Plan shall be upon shareholder approval of this Plan pursuant to California Corporations Code ss.600, which shall occur within 12 months of the date of Board approval. This Plan, but not Options already granted, shall terminate automatically ten (10) years after its adoption by the Board, unless terminated earlier by the Board under Section 13. No Options shall be granted after termination of this Plan but all Options granted prior to termination shall remain in effect in accordance with their terms.

3. NUMBER AND SOURCE OF SHARES OF STOCK SUBJECT TO THE PLAN.

Subject to the provisions of Section 8, the total number of shares of Stock with respect to which Options may be granted under this Plan is 240,000 shares of Stock. The shares of Stock covered by any canceled, expired, or terminated Option or the unexercised portion thereof shall become available again for grant under this Plan. The shares of Stock to be issued hereunder upon exercise of an Option may consist of authorized and unissued shares or treasury shares.

4. ADMINISTRATION OF THE PLAN.

This Plan shall be administered by the Compensation Committee which shall consist of at least two (2) members of the Board. The "Administrator" shall mean the "Compensation Committee" referred to in this Section 4 in its capacity as administrator of the Plan in accordance with this Section 4. The Administrator may delegate nondiscretionary administrative duties to such employees of the Company as it deems proper. A majority of the members of the Compensation Committee shall be non-employee directors within the meaning of Rule 16b-3 (b)(3)(i) of the Securities Exchange Act of 1934.

Subject to the express provisions of this Plan, the Administrator shall have the authority to construe and interpret this Plan and any agreements defining the rights and obligations of the Company and Optionees under this Plan; to further define the terms used in this Plan; to prescribe, amend, and rescind rules and regulations relating to the administration of this Plan; to determine the duration and purposes of leaves of absence which may be granted to Optionees without constituting a termination of their employment for purposes of this Plan; and to make all other determinations necessary or advisable for the administration of this Plan.

Any decision or action of the Administrator in connection with this Plan or Options granted or shares of Stock purchased under this Plan shall be final and binding. The Administrator shall not be liable for any division, action, or omission respecting this Plan, or any Options granted or shares of Stock sold under this Plan. The Board at any time may abolish the Compensation Committee and reconstitute in the Board the administration of the Plan.

To the extent permitted by applicable law in effect from time to time, no member of the Compensation Committee or the Board of Directors shall be liable for any action or omission of any other member of the Compensation Committee or the Board of Directors nor for any act or omission on the member's own part, excepting only the member's own willful misconduct or gross negligence, arising out of or related to the Plan. The Company shall pay expenses incurred by, and satisfy a judgment or fine rendered or levied against, a present or former director or member of the Compensation Committee or Board in any action against such person (whether or not the Company is joined as a party defendant) to impose liability or a penalty on such person for an act alleged to have been committed by such person while a director or member of the Compensation Committee or Board arising with respect to the Plan or administration thereof, or out of membership on the Compensation Committee or Board, or by the Company, or all or any combination of the preceding; provided, the director or Compensation Committee member was acting in good faith, within what such director or Compensation Committee member reasonably believed to have been within the scope of his or her employment or authority, and for a purpose which he or she reasonably believed to be in the best interests of the Company or its shareholders. Payments authorized hereunder include amounts paid and expenses incurred in settling any such action or threatened action. The provisions of this section shall apply to the estate, executor, administrator, heirs, legatees, or devisees of a director or Compensation Committee member, and the term "person" as used in this section shall include the estate, executor, administrator, heirs, legatees, or devisees of such person.

5. GRANT OF OPTIONS; TERMS AND CONDITIONS OF GRANT.

5.1 Grant Of Options. One or more Options may be granted to any Eligible Person. Subject to the express provisions of the Plan, the Administrator shall determine from the Eligible Persons those individuals to whom Options under the Plan may be granted. Each Option so granted shall be designated by the Administrator as either a Non-qualified Stock Option or an Incentive Stock Option.

Subject to the express provisions of this Plan, the Administrator shall specify the Grant Date, the number of shares of Stock covered by the Option, the exercise price, and the terms and conditions for exercise of the Options. If the Administrator fails to specify the Grant Date, the Grant Date shall be the date of the action taken by the Administrator to grant the Option. As soon as practicable after the Grant Date, the Company shall provide the Optionee with a written Option Agreement in the form approved by the Administrator, which sets

out the Grant Date, the number of shares of Stock covered by the Option, the exercise price, and the terms and conditions for exercise of the Option.

The Administrator may, in its absolute discretion, grant Options under this Plan to an Eligible Person at any time and from time to time before the expiration of ten (10) years from the Effective Date.

5.2 General Terms And Conditions. Except as otherwise provided herein, the Options shall be subject to the following terms and conditions and such other terms and conditions not inconsistent with this Plan as the Administrator may impose.

5.3 Exercise Of Option. In order to exercise all or any portion of any Option granted under this Plan, an Optionee must remain as an officer, employee, consultant, or director of the Company, until the Vesting Date. The Option shall be exercisable on or after each Vesting Date in accordance with the terms set forth in the Option Agreement.

5.4 Option Term. Each Option and all rights or obligations thereunder shall expire on such date as shall be determined by the Administrator, but not later than ten (10) years after the grant of the Option (five (5) years in the case of an Incentive Stock Option when the Optionee owns more than 10% of the total combined voting power of all classes of Stock of the Company), and shall be subject to earlier termination as hereinafter provided.

5.5 Exercise Price. The Exercise Price of any Option shall be determined by the Administrator, but in the case of Incentive Stock Options shall not be less than 100% (110% in the case of an Optionee who owns more than 10% of the total combined voting power of all classes of stock of the Company) of the Fair Market Value of the Stock on the date the Incentive Stock Option is granted, and 100% of the Fair Market Value of the Stock on the date the Non-qualified Stock Option is granted.

5.6 Method Of Exercise. To the extent the right to purchase shares of Stock has accrued, Options may be exercised, in whole or in part, from time to time in accordance with their terms by written notice from the Optionee to the Company stating the number of shares of Stock with respect to which the Option is being exercised, and accompanied by payment in full of the exercise price. Payment may be made in cash or check.

5.7 Restrictions On Stock; Option Agreement. At the time it grants Options under this Plan, the Company may retain, for itself or others, rights to repurchase the shares of Stock acquired under the Option, or impose other restrictions on such shares. The terms and conditions of any such rights or other restrictions shall be set forth in the Option Agreement evidencing the Option. No Option shall be exercisable until after execution of the Option Agreement by the Company and the Optionee.

5.8 Non-Assignability Of Option Rights. No Option shall be transferable other than by will or by the laws of descent and distribution. During the lifetime of an Optionee, only the Optionee may exercise an Option.

5.9 Exercise After Certain Events.

5.9.1 Termination as an employee, director, or consultant. If for any reason other than permanent and total disability or death (as defined below) an Optionee ceases to be employed by or to be a consultant or director of the Company, Options held at the date of such termination (to the extent then exercisable) may be exercised, in whole or in part, at any time within three (3) months after the date of such termination or such lesser period specified in the Option Agreement (but in no event after the earlier of (i) the expiration date of the Option as set forth in the Option Agreement, and (ii) ten years from the Grant Date).

If an Optionee granted an Incentive Stock Option terminates employment but continues as a consultant, advisor, or in a similar capacity to the Company, Optionee need not exercise the Option within three months of termination of employment but shall be entitled to exercise within three months of termination of services to the Company (one (1) year in the event of permanent disability or death). However, if Optionee does not exercise within three (3) months of termination of employment, the Option will not qualify as an Incentive Stock Option.

5.9.2 Permanent disability and death. If an Optionee becomes permanently and totally disabled (within the meaning of section 22(e)(3) of the Code), or dies while employed by the Company, or while acting as an officer, consultant, or director of the Company, (or, if the Optionee dies within the period that the Option remains exercisable after termination of employment or affiliation), Options then held (to the extent then exercisable) may be exercised by the Optionee, the Optionee's personal representative, or by the person to whom the Option is transferred by will or the laws of descent and distribution, in whole or in part, at any time within one (1) year after the disability or death or any lesser period specified in the Option Agreement (but in no event after the earlier of (i) the expiration date of the Option as set forth in the Option Agreement, and (ii) ten (10) years from the Grant Date).

5.10 Compliance With Securities Laws. The Company shall not be obligated to issue any shares of Stock upon exercise of an Option unless such shares are at that time effectively registered or exempt from registration under the federal securities laws and the offer and sale of the shares of Stock are otherwise in compliance with all applicable securities laws. Upon exercising all or any portion of an Option, an Optionee may be required to furnish representations or undertakings deemed appropriate by the Company to enable the offer and sale of the shares of Stock or subsequent transfers of any interest in such shares to comply with applicable securities laws. Evidences of ownership of shares of Stock acquired upon exercise of Options shall bear any legend required by, or useful for purposes of compliance with, applicable securities laws, this Plan, or the Option Agreement evidencing the Option.

6. LIMITATIONS ON GRANT OF INCENTIVE STOCK OPTIONS.

6.1 One Hundred Thousand Dollars Rule. The aggregate Fair Market Value (determined as of the Grant Date) of the Stock for which Incentive Stock Options may first become exercisable by any Optionee during any calendar year under this Plan, together with that of Stock subject to Incentive Stock Options first exercisable (other than as a result of acceleration pursuant to Section 9) by such Optionee under any other plan of the Company, shall not exceed \$100,000.

6.2 Option Agreements. There shall be imposed in the Option Agreement relating to Incentive Stock Options such terms and conditions as are required in order that the Option be an "incentive stock option" as that term is defined in section 422 of the Code.

6.3 Ten Percent Rule. No Incentive Stock Option may be granted to any person who, at the time the Incentive Stock Option is granted, owns shares of outstanding Stock possessing more than 10% of the total combined voting power of all classes of Stock of the Company, unless the exercise price of such Option is at least 110% of the Fair Market Value of the Stock (determined as of the Grant Date) subject to the Option, and such Option by its terms is not exercisable after the expiration of five (5) years from the Grant Date.

6.4 Non-Employees. No Incentive Stock Option may be granted to any person who is not an employee of the Company.

7. PAYMENT OF TAXES.

Upon the disposition by an Optionee or other person of shares of an Option prior to satisfaction of the holding period requirements of Section 422 of the Code, or upon the exercise of a Non-qualified Stock Option, the Company shall have the right to require such Optionee or such other person to pay by cash, or check payable to the Company, the amount of any taxes which the Company may be required to withhold with respect to such transactions. Any such payment must be made promptly when the amount of such obligation becomes determinable. The Administrator may, in lieu of such cash payment, withhold that number of shares sufficient to satisfy such withholding.

8. ADJUSTMENT FOR CHANGES IN CAPITALIZATION.

The existence of outstanding Options shall not affect the Company'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 Stock, the dissolution or liquidation of the Company's or any other corporation's assets or business, or any other corporate act, whether similar to the events described above or otherwise. Subject to Section 9, if the outstanding shares of the Stock are increased or decreased in number or changed into or exchanged for a different number or kind of securities of the Company or any other corporation by reason of a recapitalization, reclassification, stock split, combination of shares, stock dividend, or other event, an appropriate adjustment of the number and kind of securities with respect to which Options may be granted under this Plan, the number and kind of securities as to which outstanding Options may be exercised, and the exercise price at which outstanding Options may be exercised, will be made.

9. DISSOLUTION, LIQUIDATION, OR MERGER.

9.1 Company Not The Survivor. In the event of a dissolution or liquidation of the Company, a merger, consolidation, combination, or reorganization in which the Company is not the surviving corporation, or a sale of substantially all of the assets of the Company, any outstanding Option shall become fully vested immediately upon the Company's public announcement of any one of the foregoing. The Board of Directors shall determine, in its sole and absolute discretion, when the Company shall be deemed to survive for purposes

of this paragraph. If the Optionee does not exercise the entire Option within ninety (90) days, the Administrator, in its sole and absolute discretion, may, with respect to the unexercised portion of the Option:

9.1.1 cancel the Option upon payment to the Optionee of an amount equal to the difference between the closing price of the Stock underlying the Option quoted the day before such liquidation, dissolution, merger, consolidation, combination, or reorganization, and the exercise price of the Option; or

9.1.2 assign the Option and all rights and obligations under it to the successor entity, with all such rights and obligations being assumed by the successor entity.

9.2 Company Is The Survivor. In the event of a merger, consolidation, combination, or reorganization in which the Company is the surviving corporation, the Board of Directors shall determine the appropriate adjustment of the number and kind of securities with respect to which outstanding Options may be exercised, and the exercise price at which outstanding Options may be exercised. The Board of Directors shall determine, in its sole and absolute discretion, when the Company shall be deemed to survive for purposes of this Plan.

10. CHANGE OF CONTROL.

If there is a "change of control" in the Company, all outstanding Options shall fully vest immediately upon the Company's public announcement of such a change. A "change of control" shall mean an event involving one transaction or a related series of transactions, in which (i) the Company issues securities equal to 25% or more of the Company's issued and outstanding voting securities, determined as a single class, to any individual, firm, partnership, limited liability company, or other entity, including a "group" within the meaning of SEC Exchange Act Rule 13d-3, (ii) the Company issues voting securities equal to 25% or more of the issued and outstanding voting stock of the Company in connection with a merger, consolidation, or other business combination, (iii) the Company is acquired in a merger or other business combination transaction in which the Company is not the surviving company, or (iv) all or substantially all of the Company's assets are sold or transferred. See Section 9 with respect to Options vesting upon the occurrence of either of the events described in (iii) or (iv) of this Section 10 and the result upon the non-exercise of the Options.

11. SUSPENSION AND TERMINATION.

In the event the Board or the Administrator reasonably believes an Optionee has committed an act of misconduct, including, but not limited to, those specified below, the Administrator may suspend the Optionee's right to exercise any Option granted hereunder pending final determination by the Board or the Administrator. If the Board or Administrator determines that an Optionee has committed an act of misconduct, including, without limitation, an act of embezzlement, fraud, breach of fiduciary duty, or deliberate disregard of the Company rules, or if an Optionee makes an unauthorized disclosure of any Company trade secret or confidential information, engages in any conduct constituting unfair competition, induces any Company customer to breach a contract with the Company, or induces any principal for whom the Company acts as agent to terminate such agency relationship, neither the Optionee nor his estate shall

be entitled to exercise any Option hereunder. The determination of the Board or the Administrator shall be final and conclusive.

12. NO RIGHTS AS SHAREHOLDER OR TO CONTINUED EMPLOYMENT.

An Optionee shall have no rights as a shareholder with respect to any shares of Stock covered by an Option. An Optionee shall have no right to vote any shares of Stock, or to receive distributions of dividends or any assets or proceeds from the sale of Company assets upon liquidation until such Optionee has effectively exercised the Option and fully paid for such shares of Stock. Subject to Sections 8 and 9, no adjustment shall be made for dividends or other rights for which the record date is prior to the date title to the shares of Stock has been acquired by the Optionee. The grant of an Option shall in no way be construed so as to confer on any Optionee the rights to continued employment by the Company.

13. TERMINATION; AMENDMENT.

The Board may amend, suspend, or terminate this Plan at any time and for any reason, but no amendment, suspension, or termination shall be made which would impair the right of any person under any outstanding Options without such person's consent not unreasonably withheld. Further, any amendment which materially increases the benefits accruing to participants under this Plan shall be subject to the approval of the Company's shareholders.

14. GOVERNING LAW.

This Plan and the rights of all persons under this Plan shall be construed in accordance with and under applicable provisions of the laws of the State of California.

Exhibit 10.9

San Jose National Bank
One North Market Street
San Jose, California 95113
Phone: (408) 947-7562
Fax: (408) 947-0362
e-mail: thebank@sjnb.com

June 11, 1998

Mr. Robert Smith, CEO
Digital Power Corporation
41920 Christy Street
Fremont, CA 94538

LOAN COMMITMENT AND LETTER AGREEMENT

Dear Mr. Smith:

We are pleased to confirm to you the following Credit Facility subject to the terms and conditions set forth below:

I. PARTIES

Lender: San Jose National Bank ("Bank")
One North Market Street
San Jose, CA 95113

Borrower: Digital Power Corporation ("Borrower")
41920 Christy Street
Fremont, CA 94538

II. CREDIT FACILITY

Type: Standard (Borrowing Base) line of credit having an inventory subfeature.

Term: Maturity of June 15, 1999. Advances at Borrowers request, subject to availability as determined by the Borrowing Base Certificate.

Amount: \$3,000,000 (Three Million Dollars).

Collateral: Broadform UCC-1 filing on all business assets with a priority filing in accounts receivable.

Payments: Monthly interest only payments. Principal at maturity.

Rate & Fee: Bank's Prime Rate, floating. \$500 documentation fee.

Guarantor: None.

III. CONDITIONS

- 1) Satisfactory execution of all Bank documents.
- 2) In consideration of the rate charged and the credit extended, Borrower will maintain its primary commercial banking relationship with Bank.
- 3) Borrower to maintain general insurance coverage naming Bank as loss payee.
- 4) Borrower to provide quarterly, internally prepared financial statements within 45 days of quarters end. Financial statements are to show the consolidated and separate results of Digital Power and Gresham Power (next due August 15, 1998).
- 5) To provide a CPA audited financial statement within 120 days of each fiscal year end (next due April 30, 1999).
- 6) To provide monthly A/R & A/P and inventory breakdown report accompanied by a Bank provided Borrowing Base Certificate within 20 days of month end (next due by July 20, 1998).
- 7) Advances under the line of credit are subject to a 80% advance rate on eligible receivables. Ineligible receivables include those receivables which are over 60 days delinquent, those which have concentrations in excess of 15% (Foresight will be allowed a 25% concentration), those which have 25% or more over 90 days delinquent, intercompany, foreign, contra, employee and government accounts.
- 8) The advance rate on inventory will be \$500,000 or 20% of total inventory, whichever is less; borrower to maintain U.S. inventory in the minimum amount of \$500,000.
- 9) An annual accounts receivable audit will be required with the next due in April 1999. All audits are to be deemed satisfactory to the bank. In lieu of future audits, borrower can allow its outside CPA to provide work papers verifying A/R and Inventory audit results. 10) Financial covenants consist of the following and will be calculated using the consolidated financial statement figures:
 - a) Quarterly profitability.
 - b) Maintain a maximum debt to tangible net worth ratio of 1.50 to 1. Currently .98 to 1.
 - c) Maintain a tangible net worth of \$6,250,000. Currently \$7,051,000. 11) Borrower will not seel, hypothecate or encumber its interest in Gresham Power Electronics without Bank's prior approval.

Upon any default by Borrower under any of the terms or conditions of this agreement, or under the events of default listed in said note, or if a default occurs in any other loan or obligation to San Jose National Bank by you or in any other credit obligation by Borrower, these loans and/or lines of credit shall, at the option of the Bank, immediately terminate and Bank may declare all sums of principal and interest remaining unpaid on loans made and note issued under these line of credit and loans immediately due and payable without notice.

Your acknowledgment of this letter shall constitute acceptance of the foregoing terms and conditions. Unless accepted, this commitment shall expire on June 30, 1998.

We appreciate the opportunity to make this commitment to you and look forward to a long and mutually beneficially relationship.

Sincerely,

By: */s/ Tim Johnson*

 Tim Johnson
 Vice President

Acknowledged and agreed to:

DIGITAL POWER CORPORATION

By: */s/ Robert Smith*

 Robert Smith
 President & CEO

Exhibit 10.10**PROMISSORY NOTE**

Principal	Loan Date	Maturity	Loan No.	Call	Collateral	Account	Officer	Initials
\$3,000,000.00	06-15-1998	06-15-1999	1071513796R	50/74	UCC	1071513796R	TAJ	

References in the shaded area are for Lender's use only and do not limit the applicability of this document to any particular loan or item

Borrower: DIGITAL POWER CORPORATION (TIN: 94-1721931) Lender: SAN JOSE NATIONAL BANK
 41920 CHRISTY STREET P. O. BOX 1957 JOHN ST., SUITE 710
 FREMONT, CA 94538 ONE NORTH MARKET STREET
 SAN JOSE, CA 95113

Principal Amount: \$3,000,000.00 Initial Rate: 8.500% Date of Note: June 15, 1998

PROMISE TO PAY. DIGITAL POWER CORPORATION ("Borrower") promises to pay to SAN JOSE NATIONAL BANK ("Lender"), or order, in lawful money of the United States of America, the principal amount of Three Million & 00/100 Dollars (\$3,000,000.00) or so much as may be outstanding, together with interest on the unpaid outstanding principal balance of each advance. Interest shall be calculated from the date of each advance until repayment of each advance.

PAYMENT. Borrower will pay this loan on demand, or if no demand is made, in one payment of all outstanding principal plus all accrued unpaid interest on June 15, 1999. In addition, Borrower will pay regular monthly payments of accrued unpaid interest beginning July 15, 1998, and all subsequent interest payments are due on the same day of each month after that. The annual interest rate for this Note is computed on a 365/360 basis; that is, by applying the ratio of the annual interest rate over a year of 360 days, multiplied by the outstanding principal balance, multiplied by the actual number of days the principal balance is outstanding. Borrower will pay Lender at Lender's address shown above or at such other place as Lender may designate in writing. Unless otherwise agreed or required by applicable law, payments will be applied first to accrued unpaid interest, then to principal, and any remaining amount to any unpaid collection costs and late charges.

VARIABLE INTEREST RATE. The interest rate on this Note is subject to change from time to time based on changes in the index which is Lender's Prime Rate (the "Index"). This is the rate Lender charges, or would charge, on 90-day unsecured loans to the most creditworthy corporate customers. This rate may or may not be the lowest rate available from Lender at any given time. Lender will tell Borrower the current Index rate upon Borrower's request. Borrower understands that Lender may make loans based on other rates as well. The interest rate change will not occur more often than each DAY. The Index currently is 8.500%. The interest rate to be applied to the unpaid principal balance of this Note will be at a rate equal to the Index, resulting in an initial rate of 8.500%. NOTICE: Under no circumstances will the interest rate on this Note be more than the maximum rate allowed by applicable law.

PREPAYMENT; MINIMUM INTEREST CHARGE. Borrower agrees that all loan fees and other prepaid finance charges are earned fully as of the date of the loan and will not be subject to refund upon early payment (whether voluntary or as a result of default), except as otherwise required by law. In any event, even upon full prepayment of this Note, Borrower understands that Lender is entitled to a minimum interest charge of \$100.00. Other than Borrower's obligation to pay any minimum interest charge, Borrower may pay without penalty all or a portion of the amount owed earlier than it is due. Early payments will not, unless agreed to by Lender in writing, relieve Borrower of Borrower's obligation to continue to make payments of accrued unpaid interest. Rather, they will reduce the principal balance due.

LATE CHARGE. If a payment is 10 days or more late, Borrower will be charged 5.000% of the regularly scheduled payment or \$25.00, whichever is greater.

DEFAULT. Borrower will be in default if any of the following happens: (a) Borrower fails to make any payment when due. (b) Borrower breaks any promise Borrower has made to Lender, or Borrower fails to comply with or to perform when due any other term, obligation, covenant, or condition contained in this Note or any agreement related to this Note, or in any other agreement or loan Borrower has with Lender. (c) Any representation or statement made or furnished to Lender by Borrower or on Borrower's behalf is false or misleading in any material respect either now or at the time made or furnished. (d) Borrower becomes insolvent, a receiver is appointed for any part of Borrower's property, Borrower makes an assignment for the benefit of creditors, or any proceeding is commenced either by Borrower or against Borrower under any bankruptcy or insolvency laws.

(e) Any creditor tries to take any of Borrower's property on or in which Lender has a lien or security interest. This includes a garnishment of any of Borrower's accounts with Lender. (f) Any guarantor dies or any of the other events described in this default section occurs with respect to any guarantor of this Note. (g) A material adverse change occurs in Borrower's financial condition, or Lender believes the prospect of payment or performance of the indebtedness is impaired.

If any default, other than a default in payment, is curable and if Borrower has not been given a notice of a breach of the same provision of this Note within the preceding twelve (12) months, it may be cured (and no event of default will have occurred) if Borrower, after receiving written notice from Lender demanding cure of such default: (a) cures the default within fifteen (15) days; or (b) if the cure requires more than fifteen (15) days, immediately initiates steps which Lender deems in Lender's sole discretion to be sufficient to cure the default and thereafter

continues and completes all reasonable and necessary steps sufficient to produce compliance as soon as reasonably practical.

LENDER'S RIGHTS. Upon default, Lender may declare the entire unpaid principal balance on this Note and all accrued unpaid interest immediately due, without notice, and then Borrower will pay that amount. Upon Borrower's failure to pay all amounts declared due pursuant to this section, including failure to pay upon final maturity, Lender, at its option, may also , if permitted under applicable law, do one or both of the following: (a) increase the variable interest rate on this Note to 5.000 percentage points over the Index, and (b) add any unpaid accrued interest to principal and such sum will bear interest therefrom until paid at the rate provided in this Note (including any increased rate). Lender may hire or pay someone else to help collect this Note if Borrower does not pay. Borrower also will pay Lender that amount. This includes, subject to any limits under applicable law, Lender's attorneys' fees and Lender's legal expenses whether or not there is a lawsuit, including attorneys' fees and legal expenses for bankruptcy proceedings (including efforts to modify or vacate any automatic stay or injunction), appeals, and any anticipated post-judgment collection services. Borrower also will pay any court costs, in addition to all other sums provided by law. This Note has been delivered to Lender and accepted by Lender in the State of California. If there is a lawsuit, Borrower agrees upon Lender's request to submit to the jurisdiction of the courts of SANTA CLARA County, the State of California. Lender and Borrower hereby waive the right to any jury trial in any action, proceeding, or counterclaim brought by either Lender or Borrower against the other. This Note shall be governed by and construed in accordance with the laws of the State of California.

DISHONORED ITEM FEE. Borrower will pay a fee to Lender of \$15.00 if Borrower makes a payment on Borrower's loan and the check or preauthorized charge with which Borrower pays is later dishonored.

RIGHT OF SETOFF. Borrower grants to Lender a contractual security interest in, and hereby assigns, conveys, delivers, pledges, and transfers to Lender all Borrower's right, title and interest in and to, Borrower's accounts with Lender (whether checking, savings, or some other account), including without limitation all accounts held jointly with someone else and all accounts Borrower may open in the future, excluding however all IRA and Keogh accounts, and all trust accounts for which the grant of a security interest would be prohibited by law. Borrower authorizes Lender, to the extent permitted by applicable law, to charge or setoff all sums owing on this Note against any and all such accounts.

COLLATERAL. This Note is secured by a SECURITY AGREEMENT DATED JANUARY 20, 1998 AND A UCC FILING DATED APRIL 28, 1994, RECORDED AS INSTRUMENT #94106664 ON MAY 27, 1994, WITH THE SECRETARY OF STATE IN SACRAMENTO.

LINE OF CREDIT. This Note evidences a revolving line of credit. Advances under this Note may be requested orally by Borrower or by an authorized person. Lender may, but need not, require that all oral requests be confirmed in writing. All communications, instructions, or directions by telephone or otherwise to Lender are to be directed to Lender's office shown above. The following party or parties are authorized to request advances under the line of credit until Lender receives from Borrower at Lender's address shown above written notice of revocation of their authority: ROBERT SMITH, PRESIDENT; PHILIP G. SWANY, SECRETARY; and JOSEPHINE JACKEWICZ, CONTROLLER. Borrower agrees to be liable for all sums either: (a) advanced in accordance with the instructions of an authorized person or (b) credited to any of Borrower's accounts with Lender. The unpaid principal balance owing on this Note at any time may be evidenced by endorsements on this Note or by Lender's internal records, including daily computer printouts. Lender will have no obligation to advance funds under this Note if: (a) Borrower or any guarantor is in default under the terms of this Note or any agreement that Borrower or any guarantor has with Lender, including any agreement made in connection with the signing of this Note; (b) Borrower or any guarantor ceases doing business or is insolvent; (c) any guarantor seeks, claims or otherwise attempts to limit, modify or revoke such guarantor's guarantee of this Note or any other loan with Lender; or (d) Borrower has applied funds provided pursuant to this Note for purposes other than those authorized by Lender.

LETTER AGREEMENT. THIS NOTE IS SUBJECT TO, AND SHALL BE GOVERNED BY, ALL THE TERMS AND CONDITIONS OF THE LETTER AGREEMENT DATED JUNE 11, 1996, BETWEEN THE BORROWER(S) AND SAN JOSE NATIONAL BANK, WHICH LETTER AGREEMENT IS INCORPORATED HEREIN BY REFERENCE.

GENERAL PROVISIONS. This Note is payable on demand. The inclusion of specific default provisions or rights of Lender shall not preclude Lender's right to declare payment of this Note on its demand. Lender may delay or forgo enforcing any of its rights or remedies under this Note without losing them. Borrower and any other person who signs, guarantees or endorses this Note, to the extent allowed by law, waive any applicable statute of limitations, presentment, demand for payment, protest and notice of dishonor. Upon any change in the terms of this Note, and unless otherwise expressly stated in writing, no party who signs this Note, whether as maker, guarantor, accommodation maker or endorser, shall be released from liability. All such parties agree that Lender may renew or extend (repeatedly and for any length of time) this loan, or release any party or guarantor or collateral; or impair, fail to realize upon or perfect Lender's security interest in the collateral; and take any other action deemed necessary by Lender without the consent of or notice to anyone. All such parties also agree that Lender may modify this loan without the consent of or notice to anyone other than the party with whom the modification is made.

PRIOR TO SIGNING THIS NOTE, BORROWER READ AND UNDERSTOOD ALL THE PROVISIONS OF THIS NOTE, INCLUDING THE VARIABLE INTEREST RATE PROVISIONS. BORROWER AGREES TO THE TERMS OF THE NOTE AND ACKNOWLEDGES RECEIPT OF A COMPLETED COPY OF THE NOTE.

BORROWER:

DIGITAL POWER CORPORATION

By: /s/ Robert Smith

ROBERT SMITH, PRESIDENT

By: /s/ Philip G Swany

PHILIP G. SWANY, SECRETARY

Exhibit 21.1

SUBSIDIARIES OF DIGITAL POWER CORPORATION

Poder Digital S. A. de C.V., a Mexican corporation

Digital Power Limited, a United Kingdom corporation

ARTICLE 5

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE FORM 10-KSB FOR THE FISCAL YEAR ENDED DECEMBER 31, 1998, FOR DIGITAL POWER CORPORATION AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

PERIOD TYPE	12 MOS
FISCAL YEAR END	DEC 31 1998
PERIOD END	DEC 31 1998
CASH	867,607
SECURITIES	0
RECEIVABLES	3,852,038
ALLOWANCES	(292,000)
INVENTORY	4,864,520
CURRENT ASSETS	10,228,722
PP&E	2,708,646
DEPRECIATION	(1,306,413)
TOTAL ASSETS	12,990,819
CURRENT LIABILITIES	5,227,406
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	9,012,679
OTHER SE	(1,493,908)
TOTAL LIABILITY AND EQUITY	12,990,819
SALES	18,733,470
TOTAL REVENUES	18,733,470
CGS	14,778,103
TOTAL COSTS	14,778,103
OTHER EXPENSES	4,531,937
LOSS PROVISION	0
INTEREST EXPENSE	(236,968)
INCOME PRETAX	(828,588)
INCOME TAX	(258,000)
INCOME CONTINUING	(570,588)
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	(570,588)
EPS PRIMARY	(.21)
EPS DILUTED	(.21)

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