DIGITAL POWER CORP

FORM 10KSB
(Annual Report (Small Business Issuers))

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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

(Mark One)

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 1999

[ ] 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

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 x/ 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, 1999, were $15,354,018.

As of March 30, 2000, the aggregate market value of the voting common stock held by non-affiliates was approximately $9,104,501 based on the closing price of $3.75 per share.

As of March 30, 2000, the number of shares of common stock outstanding was 2,804,435.

Transitional Small Business Disclosure Format (check one): Yes No x/

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 Corporation ("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 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.

1999 Activity

Throughout most of 1999, the Company continued to experience softness in demand for most of its product lines. This resulted in a decrease in revenues from $18,733,470 in 1998 to $15,354,018 in 1999. The Company instituted several cost saving measures including headcount reductions, primarily in its production facilities in Mexico, as well as a 10% salary and wage reduction which affected all of its employees in the US operations, effective January 1999. During this same time period, however, the Company recognized the need to update its product offering and initiated an aggressive new product development campaign. These efforts have yielded the UPF150 product family which has been released to production, as well as substantial progress on the development of the Company's recently announced ePower300 and UPF200. These factors produced a loss of $155,536 in the first quarter and a modest net income of $27,191 for the year.

Digital Power Limited

In 1998, Digital Power acquired the assets of Gresham Power Electronics. Through its wholly-owned subsidiary, Digital Power Limited, 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 Power'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, Dot Hill, Motorola, Stanford Telecommunications, Extreme Networks, Foundry Networks, JDS Uniphase, Ericsson, British Telecom and Lucent.

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 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.

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 1999.

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 20% 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 1999, the Company had revenues of $15,354,018 and net income of $27,191 compared to revenues of $18,733,470 and a net loss of $(570,588) during fiscal year 1998.

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, 1999 and 1998, distributor sales accounted for 31.6% and 29.1%, respectively, of the Company's total sales. Over this same period, one distributor accounted for 11.5% and 13.1%, 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, 1999 and 1998, private label sales accounted for 3.7% and 8.2%, 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 1999 or 1998. As of December 31, 1999, the Company's warranty reserve was $212,782.

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 $952,690 and $1,397,816 for the years ended December 31, 1999 and 1998, respectively, and represented 6.20% and 7.46% of the Company's total revenues for the corresponding periods.

Employees

As of December 31, 1999, the Company had approximately 285 full-time employees, with 210 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 20% 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 1999, the Company lost $6,236 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, 1998, one OEM accounted for 13% of the Company's total revenues. For the year ended December 31, 1999, one OEM customer accounted for 11.0% 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, 1999, approximately $940,000 was outstanding. The credit facility bears interest based upon the lender's prime rate, is due September 15, 2000, and is secured by all of the Company's assets. Under terms of the loan agreement, the Company is in compliance with covenants requiring that the Company be profitable three of four quarters and maintain certain debt to tangible net worth ratios. Gresham Power also has a credit facility of $800,000 of which none was outstanding at December 31, 1999.

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 20% 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 $6,653 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 $4,583 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. 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 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.

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 valued at $60,156 and will pay $150,000 in monthly payments, beginning in October 1998.

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 provided Mr. Valencia employment for six months at the hourly rate of $18.50, 40 hours per week. Mr Valencia's term of employment ended 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 is listed and traded on the American Stock Exchange ("AMEX") under the symbol DPW. Previously, Digital Power had Redeemable Common Stock Purchase Warrants which were listed and traded on the AMEX under the symbol DPW+. Under the terms of the Warrants, the Warrants expired on December 16, 1999. Information regarding the Warrants are for historical purpose only. The following tables set forth the high and low closing sale prices, as reported by AMEX, for Digital Power's Common Stock and Warrants for the prior two fiscal years.

Common Stock		
Period	Low	High
Quarter ending December 31, 1999	$1.25	$1.94
Quarter ending September 30, 1999	$1.50	$2.06
Quarter ending June 30, 1999	$1.38	$2.06
Quarter ending March 31, 1999	$1.31	$2.38

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

Redeemable Common Stock Purchase Warrants(1)		
Period	Low	High
Quarter ending December 31, 1999	$ .00	$ .06
Quarter ending September 30, 1999	$ .06	$ .19
Quarter ending June 30, 1999	$ .06	$ .19
Quarter ending March 31, 1999	$ .25	$ .32
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

(1) Under the terms of the Warrants, the Warrants expired on December 16, 2000.

(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.

(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, 1999 and 1998.

	Years Ended December 31,	
	1999	1998
Revenues	100.00	100.00
Cost of goods sold	73.45	78.89
Gross margin	26.55	21.11
Selling, general and administrative	18.26	16.73
Research and development	6.20	7.46
Total operating expense	24.46	24.19
Operating income	2.09	(3.08)
Net interest expense	1.07	1.14
Translation loss	.04	.20
Income (Loss) before income taxes	.98	(4.42)
Provision (Benefit) for income taxes	.80	(1.37)
Net (Loss) Income	.18%	(3.05)%

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, 1999, Compared to Year Ended December 31, 1998

Revenues

Revenues for the fiscal year ended December 31, 1999, were $15,354,018, which represented a decrease of $3,379,452, or approximately 18%, from revenues of $18,733,470 for the year ended December 31, 1998. This decrease in total revenues includes a 8% decrease in revenues of $532,424 from Gresham Power with revenues of $7,002,041 and $6,469,617 for the fiscal years ended December 31, 1998 and 1999. The decrease in revenues was due primarily to a reduction in sales and marketing efforts and a re-allocation of these resources to new product development initiatives in the U.S.

Gross Margin

Gross margins were 26.55% for the year ended December 31, 1999, compared to 21.11% for the fiscal year ended December 31, 1998. This increase in gross margins can be primarily attributed to aggressive cost containment measures initiated by the Company including headcount reductions in the U.S. and Mexico, and a 10% salary and wage reduction which affected all of its U.S. employees.

Selling, General and Administrative

Total selling, general and administrative expenses decreased by $330,628 to $2,803,493 for the year ended December 31, 1999, from $3,134,121 for the fiscal year ended December 31, 1998, primarily due to reduced U.S. payroll related expenses and commissionable sales. Gresham Power selling, general and administrative expenses increased $349,015 from $1,289,006 in 1998 to $1,638,021 for the fiscal year ended December 31, 1999, primarily due to the hiring of a full time sales manager responsible for the sales and distribution of Digital Power designs and products in the U.K. and Europe, with related increased travel, trade show expense and advertising.

Research and Development

Research and development expenses were $952,690 for the year ended December 31, 1999, as compared to $1,397,816 for the year ended December 31, 1998. Of the $445,126 decrease, $2,390 is attributed to Gresham Power. The other additional decrease can be primarily attributed to the 1998 settlement of litigation involving KDK Electronics, with no comparable expense in 1999.

Interest Expense

Net interest expense was $147,408 for the year ended December 31, 1999, compared to $220,894 for the year ended December 31, 1998. This decrease in interest expense is primarily due to reduced borrowings on the Company line of credit which was reduced from $1,590,000 at the end of 1998, to $940,000 at the end of 1999, paid by cash savings from the 1996 IPO.

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 1999, the Company experienced a translation loss of $6,236 primarily related to Poder Digital's operations using Mexican pesos, compared with a translation loss of $37,771 in 1998.

Income (Loss) Before Income Taxes

The Company income before income taxes increased $978,779 to a $150,191 income before income taxes during 1999 from a loss before income taxes of $(828,588) during 1998. Gresham Power contributed $314,003 income before income taxes in 1999, and $237,603 income before income taxes in 1998. This increase was due primarily to the improvement in gross margins which resulted from the cost containment initiatives, as discussed in the gross margin section.

Income Tax

For the year ended December 31, 1999, the Company had an income tax expense of $123,000 compared to a tax benefit of $258,000 due to its 1998 net loss for the year ended December 31, 1998. Gresham Power income tax expense was $120,983 in 1999 and $120,983 in 1998.

Net Income (Loss)

The Company net income increased $597,779 to a net income of $27,191 in 1999 from a net loss of $(570,588) in 1998. Gresham Power net income was $171,003 in 1999 compared to net income of $116,620 in 1998.

The Company does not believe that its business is seasonal.

Liquidity And Capital Resources

Through December 31, 1999, the Company funded its operations primarily through revenues generated from operations, and bank borrowings. As of December 31, 1999, the Company had cash and cash equivalents of $824,708 and working capital of $5,367,917. This compares with cash and cash equivalents of $867,607 and working capital of $5,001,316 at December 31, 1998. The increase in working capital for the year ended December 31, 1999, is primarily due to the Company's income and reduction of debt. Cash provided by operating activities for the Company totaled $1,728,208 and $10,066 for the year ended December 31, 1999 and 1998 respectively. Cash used in investing activities of $161,896 during 1999 consisted primarily of expenditures for the purchase of production and testing equipment. During 1998, cash used in investing activities amounted to $3,500,586 primarily from the purchase of the assets of Gresham Power. For the year ended December 31, 1999, cash used in financing activities included payments of $1,524,302 on borrowings. During the year ended December 31, 1998, cash provided by financing activities included proceeds from borrowings of $2,366,846 and proceeds of $95,350 from the exercise of warrants and stock options, offset by payments of $300,504 on borrowings.

The Company was 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. The loan was paid during 1999, and bore 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 was paid by the ESOP through contributions made by the Company to the ESOP in the amount of approximately $8,852 per month. This amount has been a monthly charge to expense.

Year 2000 Compliance

The Year 2000 problem arises when computer programs have been written having two digits rather than four to define the applicable year. As a result, date-sensitive software and/or hardware may recognize a date having 00 as the year 1900 rather than the year 2000. This could result in a system failure or other disruption of operations and impede normal business activities.

The total cost associated with required modifications to become Year 2000 compliant is not expected to be material to Digital Power's financial position. The estimated total cost of the Year 2000 project was approximately $10,000 which was expensed as incurred. In addition, Gresham Power purchased hardware and software upgrades for approximately $150,000 that were capitalized.

Digital Power completed all phases of its Year 2000 compliance project and as of March 31, 2000, Digital Power has not encountered any material Year 2000 problems.

Although Digital Power's Year 2000 rollover did not present any material business disruption, there are some remaining Year 2000 related risks, including risks due to the fact that the Year 2000 is a leap year. Management believes that appropriate actions have been taken to address these remaining Year 2000 issues and contingency plans are in place to minimize the financial impact to Digital Power. Management, however, cannot be certain that Year 2000 issues affecting customers, suppliers or service provides of Digital Power will not have a material adverse impact on Digital Power.

Impact of Recently Issued Standards

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities," (FASB133). 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. This statement was amended by Statement of Financial Accounting Standards No. 137, issued in June 1999, such that it is effective for the Company's financial statements for the year ending December 31, 2001. 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.

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-23.

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 bylaws of Digital Power currently sets the number of directors constituting the entire board to be five (5), each to serve until the next Annual Meeting and until his successor shall be elected and qualified or until his earlier death, resignation, or removal. There are no family relationships between any of the directors and executive officers of Digital Power. The following table sets forth all the directors and executive officers of Digital Power and certain information with respect to those persons as of December 31, 1999.

Name	Age	Directors, Executive Officers and Background For the Past Five Years
Robert O. Smith	55	Chief Executive Officer and Director since 1989 and President since May 1996. From 1980 to 1989 variously served as Vice President/Group Controller of Power Conversion Group, General Manager of Compower Division, and President of Boschert subsidiary, of Computer Products, Inc., manufacturer of power conversion products and industrial automation systems. Received B.S. in Business Administration from Ohio University and completed course work in M.B.A. program at Kent State University.
Chris Schofield	43	Managing Director of Digital Power Limited since January 1998. Director and General Manager of Gresham Power Group from 1995 to 1998. From 1988 to 1995, Director of United Kingdom Operations of the Oxford Instruments Group.
Thomas W. O'Neil, Jr.	70	Director since 1991. Certified Public Accountant and Partner since 1991 of Schultze, Wallace and O'Neil, CPAs. Retired as Partner, from 1955 to 1991, of KPMG Peat Marwick. Director of California Exposition and State Fair; Director of Regional Credit Association; Director of Alternative Technology Resources, Inc. Graduate of St. Mary's College and member of the St. Mary's College Board of Regents.

Name	Age	Directors, Executive Officers and Background For the Past Five Years
Scott C. McDonald	46	Director since May 1998. Chief Financial and Administrative Officer of Conxion Corporation since December 1999. Director of Castelle Incorporated since April 1999. Director of Octant Technologies, Inc. since April 1998. From November 1996 to May 1998, director of CIDCO Incorporated, a communications and information delivery company. From October 1993 to January 1997, Executive Vice President, Chief Operating and Financial Officer of CIDCO. From March 1993 to September 1993, President, Chief Operating and Financial Officer of PSI Integration, Inc. From February 1989 to February 1993, Chief Financial Officer and Vice President, Finance of Administration of Integrated System, Inc. Received B.S. in Accounting from The University of Akron and M.B.A. from Golden Gate University.
Robert J. Boschert	63	Business consultant for small high-growth technology companies. Director since 1990 of Hytek Microsystems, Inc. From June 1986 until June 1998, served as consultant to Union Technology. Founder of Boschert, Inc. Retired as a member of the board of directors in 1984. Received B.S. in Electrical Engineering from University of Missouri.
Philip G. Swany	50	Mr. Swany joined the Company as its Controller in 1981. In February 1992, he left the Company to serve as the Controller for Crystal Graphics, Inc., a 3-D graphics software development company. In September 1995, Mr. Swany returned to the Company where he was made Vice President-Finance. In May 1996, he was named Chief Financial Officer and Secretary of the Company. Mr. Swany received a B.S. degree in Business Administration - Accounting from Menlo College, and attended graduate courses in business administration at the University of Colorado.

Committees of the Board; Meetings and Attendance

The Board has an Audit Committee and a Compensation Committee. The Audit Committee currently consists of Messrs. McDonald and O'Neil, and the Compensation Committee consists of Messrs. Boschert and McDonald. The Board does not have a Nominating Committee. The primary functions of the Audit Committee are to review the scope and results of audits by the Company's independent auditors, the Company's internal accounting controls, the non-audit services performed by the independent accountants, and the cost of accounting services. The Compensation Committee administers the Company's 1996 Stock Option Plan and the Company's 1998 Stock Option Plan upon its adoption and approves compensation, remuneration, and incentive arrangements for officers and employees of the Company.

The Board met three times during 1999, and the Audit Committee and the Compensation Committee each met one time during 1999. Each director attended at least seventy-five percent of the meetings of the Board and of the committees upon which he served except for Mr. Boschert who attended 66 2/3% of the meetings and Mr. Schofield who attended 33 1/3% of the meetings.

Compensation of Directors

Non-employee directors receive $10,000 per annum paid quarterly and options to purchase 10,000 shares of Common Stock.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

Section 16(a) of the Securities Exchange Act of 1934 requires Digital Power's directors, executive officers, and persons who own more than 10% of Digital Power's outstanding Common Stock to file reports of ownership and changes in ownership with the SEC. Directors, executive officers, and shareholders of more the 10% of Digital Power's Common Stock are required by SEC regulations to furnish Digital Power with copies of the Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to Digital Power, or written representations that such filings were not required, Digital Power believes that, during the calendar year 1999, the directors and officers complied with the Section 16(a) filing requirements.

Item 10. Executive Compensation.

Executive officers are appointed by, and serve at the discretion of, the Board of Directors. Except for Robert O. Smith, the Company's President and Chief Executive Officer, the Company has no employment agreements with any of its executive officers. The following table sets forth the compensation of the Company's President and Chief Executive Officer during the past three years. No other officer received annual compensation in excess of $100,000 during the 1999 fiscal year.

SUMMARY COMPENSATION TABLE

				Long Term Compensation			
		Annual Compensation		Awards		Payouts	
Name and Principal Position	Year	Salary	Other Annual Compensation ($)	Restricted Stock Award(s) ($)	Securities Underlying Options (#)	LTIP Payouts ($)	All Other Compensa-tion
Robert O. Smith	1999	$134,038(1)	$0	$0	100,000(2)	$0	$0
President and CEO	1998	$141,912(1)	$0	$0	100,000(3)	$0	$0
	1997	$150,000	$0	$0	100,000(4)	$0	$0

(1) Pursuant to Mr. Smith's employment contract, during 1999, Mr. Smith was entitled to receive $200,000 per annum and during 1998, was entitled to receive $175,000 per annum. Due to the financial condition of the Company, Mr. Smith only received $134,038 and $141,912 during 1999 and 1998, respectively.

(2) Represents options to acquire 100,000 shares of common stock at $1.875 per share.

(3) Pursuant to his employment contract, in January 1998, Mr. Smith received options to acquire 100,000 shares of Common Stock at $6.69 per share. These options expire in January 2008. On November 5, 1998, these options were repriced to an exercise price of $2.31 per share.

(4) Pursuant to his employment contract, in January 1997, Mr. Smith received options to acquire 100,000 shares of Common Stock at $5.4375 per share. These options expire in January 2007. On November 5, 1998, these options were repriced to an exercise price of $2.31 per share

On March 1, 2000, the Company and Mr. Smith entered into an employment contract effective January 1, 2000. The term of the employment agreement is for one year subject to annual renewal. Under the terms of Mr. Smith's employment contract, Mr. Smith shall serve as President and Chief Executive Officer of the Company and his salary shall be $200,000 per annum and be entitled to bonuses as determined by the Board. In addition, 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 as of such date or the average closing price for the first six months of each year of his contract. Pursuant to Mr. Smith's employment contract, in the event there is a change in control of the Company, Mr. Smith shall be entitled to receive in one payment, the sum of six (6) times his annual base salary. If Mr. Smith's employment agreement is not renewed or he is terminated without cause, Mr. Smith will be entitled to three times his annual base salary.

The following table sets forth the options granted to Mr. Smith during the past fiscal year.

OPTION GRANTS IN LAST FISCAL YEAR

	Individual Grants			
Name	Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year	Exercise or Base Price ($/Sh)	Expiration Date
Robert O. Smith	100,000	54.98%	$1.875	January 2009

The following table sets forth Mr. Smith's fiscal year end option values. No options were exercised by Mr. Smith during 1999.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR
AND FISCAL YEAR-END OPTION VALUES

			Number of Unexercised Options at FY-End (#)	Value of Unexercised In-the-Money Options at FY-End ($)(1)
Name	Shares Acquired on Exercise (#)	Value Realized ($)	Exercisable/ Unexercisable	Exercisable/ Unexercisable
Robert O. Smith	None	None	386,900 Exercisable	$81,469 Exercisable

(1) Market price at December 31, 1999, for a share of common stock was $1.4375.

Stock Plans

Employee Stock Purchase Plan. The Company has adopted an Employee Stock Ownership Plan ("ESOP") in conformity with ERISA requirements. As of December 31, 1999, the ESOP owns, in the aggregate, 167,504 shares of the Company's Common Stock. In June 1996, the ESOP entered into a $500,000 loan with San Jose National bank to finance the purchase of shares. The Company guaranteed the repayment of the loan, and Company contributions to the ESOP were used to pay off the loan by the end of 1999. All employees of the Company participate in the ESOP on the basis of level of compensation and length of service. Participation in the ESOP is subject to vesting over a six-year period. The shares of the Company's Common Stock owned by the ESOP are voted by the ESOP trustees. Mr. Smith, President and Chief Executive Officer of the Company, is one of two trustees of the ESOP.

1998 and 1996 Stock Option Plans

The Company has established the 1998 and 1996 Stock Option Plans (the "Plans"). The purposes of the Plans are to encourage stock ownership by employees, officers, and directors of the Company to give them a greater personal interest in the success of the business and to provide an added incentive to continue to advance in their employment by or service to the Company. A total of 753,000 options are authorized to be issued under the Plans, of which 647,980 options have been issued. The Plans provide for the grant of either incentive or non-statutory stock options. The exercise price of any incentive stock option granted under the Plans may not be less than 100% of the fair market value of the Common Stock of the Company on the date of grant. The fair market value for which an optionee may be granted incentive stock options in any calendar year may not exceed $100,000. Shares subject to options under the Plans may be purchased for cash. Unless otherwise provided by the Board, an option granted under the Plans is exercisable for ten years. The Plans are administered by the Compensation Committee which has discretion to determine optionees, the number of shares to be covered by each option, the exercise schedule, and other terms of the options. The Plans may be amended, suspended, or terminated by the Board but no such action may impair rights under a previously granted option. Each incentive stock option is exercisable, during the lifetime of the optionee, only so long as the optionee remains employed by the Company. No option is transferrable by the optionee other than by will or the laws of descent and distribution.

Other Stock Options

The Company, as of December 31, 1999, has outstanding options to acquire 92,000 shares of Common Stock at $1.80 per share and options to acquire 86,900 shares of Common Stock at $.50 per share. These options were granted to employees in May 1993 and are now fully vested.

401(k) Plan

The Company has adopted a tax-qualified employee savings and retirement plan (the "401(k) Plan"), which generally covers all of the Company's full-time employees. Pursuant to the 401(k) Plan, employees may make voluntary contributions to the 401(k) Plan up to a maximum of six percent of eligible compensation. These deferred amounts are contributed to the 401(k) Plan. The 401(k) Plan permits, but does not require, additional matching and Company contributions on behalf of Plan participants. The Company matches contributions at the rate of $.25 for each $1.00 contributed. The Company can also make discretionary contributions. The 401(k) Plan is intended to qualify under Sections 401(k) and 401(a) of the Internal Revenue Code of 1986, as amended. Contributions to such a qualified plan are deductible to the Company when made and neither the contributions nor the income earned on those contributions is taxable to Plan participants until withdrawn. All 401(k) Plan contributions are credited to separate accounts maintained in trust.

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

The following table sets forth, as of March 31, 2000, certain information with respect to the beneficial ownership of shares of Digital Power Common Stock by all shareholders known by Digital Power to be the beneficial owners of more than five percent of the outstanding shares of such Common Stock, all directors and executive officers of Digital Power individually, and all directors and all executive officers of Digital Power as a group. As of March 31, 2000, there were 2,804,435 shares of Common Stock outstanding.

Name	No. of Shares Common Stock(1)	Percent
Rhodora Finance Corporation Limited 80 Broad Street Monrovia, Liberia	183,464	6.54%
Digital Power - ESOP 41920 Christy Street Fremont, CA 94538	167,504	5.97%
Thomas W. O'Neil, Jr., Director	75,600(2)	2.65%
Robert O. Smith, Director and Chief Executive Officer	765,904(3)	22.51%
Chris Schofield, Managing Director, Digital Power Limited	-0-	-0-
Philip G. Swany, Chief Financial Officer	49,250(4)	1.73%
Scott C. McDonald, Director	10,000(5)	*
Robert J. Boschert, Director	10,000(5)	*
All directors and executive officers as a group (6 persons)	919,754(6)	24.7%

* Less than one percent.

(1) Except as indicated in the footnotes to this table, the persons named in the table have sole voting and investment power with respect to all shares of Common Stock shown as beneficially owned by them, subject to community property laws where applicable.

(2) Includes 50,000 shares subject to options and warrants exercisable within 60 days.

(3) Includes 598,400 shares subject to options and warrants exercisable within 60 days. Also includes 167,504 owned by the Digital Power ESOP of which Mr. Smith is a trustee.

(4) Represents 49,250 shares subject to options exercisable within 60 days.

(5) Includes 10,000 shares subject to options and warrants exercisable within 60 days.

(6) Includes 717,650 shares subject to options and warrants and exercisable within 60 days. Also includes 167,504 shares owned by the Digital Power ESOP of which Mr. Smith is a trustee and may be deemed a beneficial owner.

Item 12. Certain Relationships and Related Transactions.

None.

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(5)
10.10	Promissory Note(5)
10.11	Employment Agreement with Robert O. Smith
21.1	The Company's subsidiaries consist of Poder Digital S.A. de C.V., a corporation formed under the laws of Mexico, and Digital Power Limited, a corporation formed under the laws of the United Kingdom.
27.1	Financial Data Schedule

(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.

(5) Previously filed with the Commission with its Form 10-KSB for the year ended December 31, 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.

Dated: April 14, 2000	*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 *Robert O. Smith, Chief Executive Officer* *(Principal Executive Officer)*	*April 14, 2000*
/s/ Philip G. Swany *Philip G. Swany, Chief Financial Officer* *(Principal Accounting and* *Financial Officer)*	*April 14, 2000*
/s/ Robert J. Boschert *Robert J. Boschert, Director*	*April 14, 2000*
/s/ Scott C. McDonald *Scott C. McDonald, Director*	*April 14, 2000*
Thomas W. O'Neil, Jr., Director	*April 14, 2000*
/s/ Chris Schofield *Chris Schofield, Director*	*April 14, 2000*

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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, 1999, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years ended December 31, 1999 and 1998. 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, 1999, and the results of their operations and their cash flows for the years ended December 31, 1999 and 1998, in conformity with generally accepted accounting principles.

/s/HEIN + ASSOCIATES LLP

HEIN + ASSOCIATES LLP
Certified Public Accountants

Orange, California
March 15, 2000

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

DECEMBER 31, 1999

ASSETS

CURRENT ASSETS:

Cash and cash equivalents	$ 824,708
Accounts receivable - trade, net of allowance for doubtful accounts of $210,485	2,813,080
Income tax refund receivable	70,988
Other receivables	99,875
Inventories, net	4,531,261
Prepaid expenses and deposits	61,326
Deferred income taxes	360,136
Total current assets	8,761,374
PROPERTY AND EQUIPMENT, net	1,223,137
EXCESS OF PURCHASE PRICE OVER NET ASSETS ACQUIRED, net of accumulated amortization of $289,926	1,162,264
DEPOSITS	14,058
TOTAL ASSETS	$ 11,160,833

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Notes payable	$ 940,000
Current portion of capital lease obligations	43,646
Accounts payable	1,196,170
Accrued liabilities	1,213,641
Total current liabilities	3,393,457
CAPITAL LEASE OBLIGATIONS, less current portion	80,825
OTHER LONG-TERM LIABILITIES	25,000
DEFERRED INCOME TAXES	9,344
Total liabilities	3,508,626

COMMITMENTS AND CONTINGENCIES (Notes 7 and 12)

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
Additional paid-in capital	331,310
Accumulated deficit	(1,832,337)
Note receivable - stockholder	(52,200)
Accumulated other comprehensive income	192,755
Total stockholders' equity	7,652,207
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 11,160,833

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31,

	1999	1998
REVENUES	$ 15,354,018	$ 18,733,470
COST OF GOODS SOLD	11,277,170	14,778,103
Gross margin	4,076,848	3,955,367
OPERATING EXPENSES:		
Research and development	952,690	1,397,816
Marketing and selling	1,159,323	1,561,803
General and administrative	1,644,170	1,572,318
Total operating expenses	3,756,183	4,531,937
INCOME (LOSS) FROM OPERATIONS	320,665	(576,570)
OTHER INCOME (EXPENSE):		
Interest income	30,935	16,074
Interest expense	(178,343)	(236,968)
Translation loss	(6,236)	(37,771)
Gain (loss) on disposal of assets	(16,830)	6,647
Other income (expense)	(170,474)	(252,018)
INCOME (LOSS) BEFORE INCOME TAXES	150,191	(828,588)
PROVISION FOR INCOME TAX (BENEFIT) EXPENSE	123,000	(258,000)
NET INCOME (LOSS)	$ 27,191	$ (570,588)
NET INCOME (LOSS) PER COMMON SHARE:		
Basic net income (loss) per share	$ .01	$ (.21)
Diluted net income (loss) per share	$ .01	$ (.21)

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 1999 and 1998

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	ESOP SHARES	NOTE RECEIVABLE-STOCKHOLDER	ACCUMULATED OTHER COMPRE-HENSIVE INCOME	TOTAL STOCK-HOLDERS' EQUITY
	SHARES	AMOUNT						
BALANCES, January 1, 1998	2,694,485	$ 8,856,489	$ 233,762	$ (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 ESOP	-	-	-	-	140,504	-	-	140,504
Compensation recognized upon issuance of warrants	-	-	46,032	-	-	-	-	46,032
Comprehensive loss:								
Net loss	-	-	-	(570,588)	-	-	-	-
Income tax benefit arising from the exercise of employee stock options	-	-	-	-	-	-	38,366	-
Foreign currency translation adjustment	-	-	-	-	-	-	36,234	-
Total comprehensive loss	-	-	-		-	-	-	(495,988)
BALANCES, December 31, 1998	2,771,435	9,012,679	279,110	(1,859,528)	(184,919)	-	271,428	7,518,770
Contribution to ESOP	-	-	-	-	184,919	-	-	184,919
Note receivable for common stock	-	-	52,200	-	-	(52,200)	-	-
Comprehensive income:								
Net income	-	-	-	27,191				-
Foreign currency translation adjustment	-	-	-	-	-	-	(78,673)	-
Total comprehensive loss	-	-	-	-	-	-	-	(51,482)
BALANCES, December 31, 1999	2,771,435	$ 9,012,679	$ 331,310	$ (1,832,337)	$ -	$ (52,200)	$ 192,755	$ 7,652,207

See accompanying notes to these consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED
DECEMBER 31,

	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 27,191	$ (570,588)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	500,691	423,655
(Gain) loss on disposal of assets	16,830	(6,647)
Deferred income taxes	8,813	(287,927)
Warranty expense	(110,000)	140,000
Inventory reserve	30,000	230,000
Contribution to ESOP	184,919	140,504
Bad debt expense	35,547	50,000
Compensation cost recognized upon issuance of warrants	-	46,033
Income tax benefit related to exercise of stock options	-	38,366
Foreign currency translation adjustment	6,236	37,771
Stock issued for legal settlement	-	60,156
Changes in operating assets and liabilities:		
Accounts receivable	711,411	614,453
Income tax refund receivable	321,658	(392,646)
Other receivables	3,167	173,507
Inventories	303,259	434,597
Prepaid expenses and deposits	(6,062)	73,986
Other assets	26,733	(23,531)
Accounts payable	(50,685)	(1,950,562)
Accrued liabilities	(271,457)	743,896
Other long-term liabilities	(10,043)	35,043
Net cash provided by operating activities	1,728,208	10,066
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of Gresham Power Electronics	-	(3,370,293)
Purchase of property and equipment	(168,042)	(156,707)
Proceeds from sale of assets	6,146	26,414
Net cash used in investing activities	(161,896)	(3,500,586)

(Continued)

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)

FOR THE YEARS ENDED
DECEMBER 31,

	1999	1998
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and warrants	-	95,350
Principal payments on long-term debt	(184,919)	(140,504)
Principal payments on capital lease obligations	(72,537)	(7,310)
Proceeds from notes payable	-	2,366,846
Principal payments on notes payable	(1,266,846)	(160,000)
Net cash provided by (used in) financing activities	(1,524,302)	2,154,382
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(84,909)	(1,537)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(42,899)	(1,337,675)
CASH AND CASH EQUIVALENTS, beginning of period	867,607	2,205,282
CASH AND CASH EQUIVALENTS, end of period	$ 824,708	$ 867,607
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash payments for:		
Interest	$ 277,935	$ 233,982
Income taxes	$ 117,494	$ 289,872
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Acquisition of equipment through capital leases	$ 19,720	$ 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"), a California corporation, and its wholly owned subsidiaries, Poder Digital, S.A. de C.V. ("PD"), located in Guadalajara, Mexico, and Digital Power Limited ("DPL"), located in the United Kingdom, are 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 DPC and its wholly owned subsidiaries, PD and DPL. 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 that 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.

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 differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

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. At the same time sales revenue is recognized, the Company provides a reserve for estimated warranty costs and a reserve for estimated product returns.

Research and Development Costs - Research and development costs are charged to operations in the period incurred.

Foreign Currency Translation - Gains and losses from the effects of exchange rate fluctuations on transactions denominated in foreign currencies are included in the results of operations. 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 a component of accumulated other comprehensive income, a component of stockholders equity. Because PD operates in a country with a highly inflationary economy, any translation adjustment related to PD is included in the results of operations.

Earnings Per Share - Basic earnings per share excludes dilution and is computed by dividing net 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 ended December 31, 1998 were anti-dilutive and excluded from the earnings per share computation.

Use of Estimates - The preparation of the Company's consolidated financial statements in conformity with generally accepted accounting principles requires the Company's management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

The Company's consolidated 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 as prescribed by FASB123.

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 counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions described below. 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," financial instruments that subject the Company to credit risk consist of cash balances maintained in excess of federal depository insurance limits and accounts and notes receivable, which have no collateral or security. See Note 13 for major customers.

Fair Value of Financial Instruments - The estimated fair values for financial instruments under FAS 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 fair value of cash is based on its demand value, which is equal to its carrying value. The fair values of notes payable are based on borrowing rates that are available to the Company for loans with similar terms, collateral, and maturity. The estimated fair values of notes payable approximate their carrying values.

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 "Accounting for Derivative Instruments and Hedging Activities,"(FASB133). 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. This statement was amended by Statement of Financial Accounting Standards No. 137, issued in June 1999, such that it is effective for the Company's financial statements for the year ending December 31, 2001. 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.

3. INVENTORIES:

Inventories consists of the following as of December 31, 1999:

Raw materials	$ 4,017,991
Work-in-process	699,490
Finished goods	485,430
Allowance for obsolescence	(671,650)
	$ 4,531,261

4. PROPERTY AND EQUIPMENT:

Property and equipment consist of the following as of December 31, 1999:

Machinery and equipment	$ 1,375,563
Office equipment and furniture	838,311
Leasehold improvements	518,586
Transportation equipment	136,655
Accumulated depreciation and amortization	(1,645,978)
	$ 1,223,137

5. ACCRUED LIABILITIES:

Accrued liabilities consist of the following as of December 31, 1999:

Accrued payroll and benefits	$ 176,167
Accrued commissions and royalties	78,383
Accrued warranty and product return expense	272,782
Income taxes payable	207,358
Accrued legal and professional fees	168,042
Other	310,909
	$ 1,213,641

6. NOTES PAYABLE:

DPC has a $3,000,000 line of credit pursuant to a promissory note agreement. The 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. Borrowing under this line of credit bears interest based upon an index equal to the lender's prime rate (totaling 8.50% at December 31, 1999), payable monthly with outstanding principal due on demand. If no demand is made, the outstanding principal and unpaid accrued interest is due September 15, 2000. At December 31, 1999, the outstanding principal balance was $940,000. Under the terms of the agreement, the Company is required to maintain certain ratios and be in compliance with other covenants. At December 31, 1999, the Company was in compliance with all covenants.

DPL has a $800,000 line of credit pursuant to a loan agreement. Borrowing under this line of credit bears interest at 2% per annum over the Bank's Base rate (totaling 10% at December 31, 1999), payable monthly with outstanding principal due on demand. If no demand is made, the outstanding principal and accrued interest is due March 31, 2001. The loan is collateralized by substantially all of the Company's assets. At December 31, 1999, no principal or accrued interest was outstanding. Under the terms of the agreement, the Company is required to maintain certain ratios and be in compliance with other covenants. At December 31, 1999, the Company was in compliance with all covenants.

7. CAPITAL LEASE OBLIGATIONS:

The Company leases certain equipment and vehicles under agreements classified as capital leases. The cost of assets under capital leases is $181,484 and accumulated depreciation amounts to $48,701 at December 31, 1999.

The future minimum lease payments are as follows:

YEARS ENDING DECEMBER 31,	AMOUNT
2000	$ 48,732
2001	43,412
2002	27,792
2003	13,896
Total future minimum lese payments	133,832
Less amount representing interest	(9,361)
Present value of net minimum lease payments	124,471
Less Current portion	(43,646)
	$ 80,825

8. 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.

9. NOTE RECEIVABLE - STOCKHOLDER:

At December 31, 1999, the Company had a note receivable in the amount of $52,200 due from a former employee received in consideration for the exercise of stock options. The note bears interest at 5% and was paid in full in February 2000.

10. STOCK OPTIONS AND WARRANTS:

Stock Options - 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 compensation committee of 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.

The Company granted 100,000 non-qualified options to purchase the Company's stock to the president of the Company in each of the years ended December 31, 1998 and 1997, in accordance with his employment agreement. The exercise prices of $6.6875 and $5.4375 per share in 1998 and 1997, respectively, were equal to the fair market value on the dates of grant. Such options vested immediately and expire in 2008 and 2007, respectively. On November 5, 1998, these options were repriced to $2.3125, which was equal to the fair market value on that date.

On January 4, 1999, the Company issued 100,000 non-qualified options to purchase the Company's stock to the president of the Company, in accordance with his employment agreement. The exercise price of $1.8750 per share was equal to the fair market value on the date of grant. Such options vested immediately and expire in 2009.

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 compensation committee of the Board of Directors will determine the vesting period of the options, if any, and no options will be exercisable after ten years from the date of grant.

During the year ended December 31, 1998, the Company granted 254,000 options to purchase the Company's stock under the 1996 Stock Option Plan to certain employees. The exercise prices range from $4.00 to $6.1250 per share, 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 ended December 31, 1998, the Company granted 124,940 options to purchase the Company's stock under the 1998 Stock Option Plan to certain employees. The exercise price of the options is $6.25 per share, 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 ended December 31, 1999, the Company granted 70,000 options to purchase the Company's stock under the 1996 Stock Option Plan to certain employees. The exercise prices range from $1.6875 to $2.00 per share, 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.

During the year ended December 31, 1999, the Company granted 11,900 options to purchase the Company's stock under the 1998 Stock Option Plan to certain employees. The exercise prices of the options ranges from $1.5625 to $1.8750 per share, 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.

During the year ended December 31, 1999 and 1998, the Company granted non-qualified options under the 1998 plan of 30,000 and 60,000 options, respectively, to purchase the Company's stock to outside directors. The exercise prices range from $1.93 to $6.25 per share, which was equal to the fair value on the date of grant. The options vest after one year.

The following table sets forth activity for all options:

	NUMBER OF SHARES	AVERAGE EXERCISE PRICE PER SHARE
OUTSTANDING, January 1, 1998	652,900	$ 2.41
Granted	548,940	2.74
Forfeited	(100,160)	2.85
Exercised	(35,750)	1.80
OUTSTANDING, December 31, 1998	1,065,930	2.19
Granted	211,900	1.90
Forfeited	(194,200)	2.42
OUTSTANDING, December 31, 1999	1,083,630	$ 2.09

At December 31, 1999, options to purchase 40,000 shares, with a weighted average exercise price of $6.06, were exercisable at prices ranging from $6.00 to $6.25 per share.

At December 31, 1999, options to purchase 1,043,630 shares were outstanding with exercise prices ranging from $.50 to $2.31 per share, a weighted average exercise price of $1.94, and a weighted average remaining contractual life of 7.17 years. Of the outstanding options, 745,251 options were excisable at a weighted average exercise price of $1.84 with the 298,379 unvested options become exercisable as follows:

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
2000	90,283	$ 2.21
2001	85,620	2.22
2002	83,134	2.22
2003	27,978	2.03
2004	11,364	1.93
	298,379	$ 2.19

If not previously exercised the outstanding options, with a weighted average contractual life of 7.25 years will expire as follows:

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
2003	279,150	$ 1.40
2004	-	-
2005	-	-
2006	192,000	2.07
2007	227,800	2.31
2008	274,680	2.53
2009	110,000	2.34
	1,083,630	$ 2.09

Warrants - In January 1998, the Company issued warrants to purchase 30,000 shares of common stock at $7.00 per share granted, to an investor relations firm for services provided. Compensation expense of $46,032 was recognized upon issuance of the warrants. The warrants are immediately exercisable and expire in January 2001.

In March 1997, the Company issued warrants to purchase 15,000 shares of common stock at $6.75 per share granted, for marketing services provided. Compensation expense of $35,903 was recognized upon issuance of the warrants. The warrants are immediately exercisable and expire in March 2000.

The following represents all activity that took place for warrants issued:

	NUMBER OF SHARES	AVERAGE EXERCISE PRICE PER SHARE
OUTSTANDING, January 1, 1998	814,290	$ 5.02
Granted	30,000	7.00
Exercised	(6,200)	5.00
OUTSTANDING, December 31, 1998	838,090	5.09
Expired	(793,090)	5.11
OUTSTANDING, December 31, 1999	45,000	$ 6.92

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 1999 and 1998, 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:

	1999	1998
Net loss	$ (326,681)	$ (1,472,924)
Net loss per common share:		
Basic and diluted	$ (.12)	$ (.59)

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 $.64 and $2.74 per share for 1999 and 1998, respectively. The following assumptions were used for grants in 1999 and 1998: average risk-free interest rates of 4.6% and 5.6%, respectively; expected lives of two years, dividend yield of 0%; and expected volatility of 55.0% 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 DECEMBER 31, 1999	1998
BASIC		
Net income (loss) applicable to common shareholders	$ 27,191	$ (570,588)
Weighted average number of common shares	2,771,435	2,726,631
Basic earnings (loss) per share	$ .01	$ (.21)
DILUTED		
Net income (loss) applicable to common shareholders	$ 27,191	$ (570,588)
Weighted average number of common shares	2,771,435	2,726,631
Common stock equivalent shares representing shares issuable upon exercise of stock options	61,447	-
Weighted average number of shares used in calculation of diluted income (loss) per share	2,832,882	2,726,631
Diluted earnings (loss) per share	$ .01	$ (.21)

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,	
2000	$ 275,446
2001	154,643
2002	134,284
2003	129,242
2004	128,820
Thereafter	611,895
	$ 1,434,330

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, 1999. Changes in the conversion rate will have an impact on the Company's required minimum payments and its operating results.

Rent expense was $253,530 and $243,154 for 1999 and 1998, 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 valued at $60,156. The shares were issued upon the close of the agreement. The $150,000 is due in installments through June 2000. As of December 31, 1999, the Company had paid $118,000 in installments with the remaining $32,000 being included in accrued liabilities.

EMPLOYMENT AGREEMENT - The Company has an employment contract with its President/CEO that terminates on December 31, 2000. The contract provides for an automatic one-year renewal unless terminated by either the Company or the employee. Under the terms of the employment contract, he shall serve as president and chief executive officer of the Company for a salary of $200,000 per annum. 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. Also, pursuant to the employment contract, in the event there is a change in control of the Company, the employee shall be paid, in one payment, the sum of six times the annual base salary for the year preceding the announcement of the change in control. Finally, pursuant to the employment contract, in the event of termination without cause, the employee shall receive in one lump sum an amount equal to three times the employees base salary for the year preceding the termination.

13. MAJOR CUSTOMERS:

The Company frequently sells large quantities of inventory to its customers. For the year ended December 31, 1999, two customers each accounted for 11% of the Company's net sales. For the year ended December 31, 1998, two customers accounted for 13% and 10%, respectively, of the Company's net sales. At December 31, 1999, approximately $417,000 or 15% of the Company's net accounts receivable were due from two customers.

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 $11,400 and $17,073 for 1999 and 1998, respectively. The Board of Directors of DPC elected not to make a discretionary contribution to the Plan for 1999 or 1998.

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 $71,400 and $50,145 to the plan for the years ended December 31, 1999 and 1998, respectively.

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.

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 bore interest at 8.5% per annum and required monthly payments of principal and interest of $8,852 through June 2001. 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 was required to contribute amounts to the plan to sufficiently cover the debt payments. Contributions to the plan in 1999 and 1998 were $184,919 and $165,971, respectively. As of December 31, 1999, the Company has repaid the loan.

15. INCOME TAXES:

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

	FOR THE YEARS ENDED DECEMBER 31,	
	1999	1998
Current		
Federal	$ (28,000)	$ (32,000)
State	1,000	(60,000)
Foreign	143,000	121,000
	116,000	29,000
Deferred		
Federal	2,000	(234,000)
State	5,000	(53,000)
Foreign	-	-
	7,000	(287,000)
	$ 123,000	$ (258,000)

The components of the net deferred tax asset and liability recognized as of December 31, 1999 are as follows:

Current deferred tax assets (liabilities):

Accounts receivable, principally due to allowance for doubtful accounts	$ 84,294
Compensated absences, principally due to accrual for financial reporting purposes	28,113
Accrued commissions	14,725
Inventory reserve	204,714
Warranty reserve	78,273
Stock rotation liability	24,084
Accrued settlement	12,845
Accrued other	10,404
Book compensation for stock options	79,038
Effect of change in tax accounting method	(109,599)
UNICAP	23,896
State taxes	272
	451,059
Valuation allowance	(90,923)
Net current deferred tax asset	$ 360,136
Long-term deferred tax assets (liabilities):	
Net operating loss carryforwards	7,667
Depreciation	(17,011)
Net long-term deferred tax liability	$ (9,344)

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 DECEMBER 31,	
	1999	1998
Total expense (benefit) computed by applying the U.S. statutory rate	34.0%	(34.0%)
Permanent differences	2.3	.8
State income taxes	3.8	(13.5)
Tax effect resulting from foreign activities	41.5	7.4
Change in valuation allowance	-	10.8
Change in beginning balance of deferred asset	-	(8.2)
Effect of IRS examination	-	5.4
Other	-	.6
	81.6%	(30.7%)

16. ACCUMULATED OTHER COMPREHENSIVE INCOME BALANCES:

Accumulated other comprehensive income consists of the following as of December 31, 1999:

	Foreign Currency Translation	Compensation related to exercise of stock options	Total Accumulated Other Comprehensive Income
Beginning Balance	$ 36,234	$ 235,194	$ 271,428
Current-period change	(78,673)	-	(78,673)
	$ (42,439)	$ 235,194	$ 192,755

17. 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 operations are measured consistent with accounting policies used in these consolidated financial statements. Segment information is as follows:

	1999				
	DPC	PD	DPL	Eliminations	Totals
Revenues	$ 8,864,412	$ 19,989	$ 6,469,617	$	$ 15,354,018
Intersegment Revenues	$ 221,138	$ 2,150,000	$ -	$ (2,371,138)	$ -
Interest Income	$ 128,106	$ 3,806	$ 12,936	$ (113,913)	$ 30,935
Interest Expense	$ 130,173	$ 7,098	$ 154,985	$ (113,913)	$ 178,343
Depreciation and Amortization	$ 161,489	$ 49,358	$ 289,844	$ -	$ 500,691
Income Tax Expense	$ (20,000)	$ -	$ 143,000	$ -	$ 123,000
Net Income	$ (67,139)	$ (76,673)	$ 171,003	$ -	$ 27,191
Segment Assets	$ 9,251,925	$ 829,095	$ 4,924,991	$ (3,845,178)	$ 11,160,833
Expenditures for Segment Assets	$ 42,281	$ 51,687	$ 93,794	$ -	$ 187,762

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	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 (Benefit)	$ (378,983)	$ -	$ 120,983	$ -	$ (258,000)
Net (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

EMPLOYMENT AGREEMENT

This EMPLOYMENT AGREEMENT (the "Agreement"), effective as of January 1, 2000 (the "Effective Date"), is entered into by and between Digital Power Corporation, a California corporation (the "Company"), and Robert O. Smith ("Employee").

RECITALS

WHEREAS, the Company and Employee entered into that certain "Employment Agreement" dated as of October 1, 1996 (the "Original Employment Agreement"), which Original Employment Agreement had a three-year term commencing on January 1, 1997, and continuing until December 31, 1999, which Original Employment Agreement has now expired; and

WHEREAS, the Company and Employee now wish to enter into a new Employment Agreement under the terms and conditions set forth herein;

NOW, THEREFORE, in consideration of the mutual promises and covenants made herein, the parties hereto AGREE AS FOLLOWS:

ARTICLE I
EMPLOYMENT AND TERM OF EMPLOYMENT

1.1. Employment and Term. The Company hereby employs Employee to render full-time services to the Company on an exclusive basis (except Employee may work one day per week from home), upon the terms and conditions set forth below, from the effective date of this Agreement until the employment relationship is terminated in accordance with the provisions of this Agreement. This Agreement shall be for an initial term from the Effective Date until December 31, 2000, and thereafter for an automatically renewable term of one year from January 1st to December 31st of each year, unless terminated earlier as provided for herein (the "Employment Term"). If this Agreement is not renewed by the Company for the subsequent year pursuant to a written notice from the Company to Employee delivered prior to December 1st of the applicable year, such non-renewal will be deemed to be a "Termination without Cause" and Employee shall be entitled to the amounts set forth in Section 4.3 hereof.

1.2. Acceptance. Employee hereby accepts employment with the Company and agrees to devote his full-time attention and best efforts exclusively to rendering the services described below. The Employee shall accept and follow the direction and authority of the Board of Directors of the Company (the "Board") in the performance of his duties, and shall comply with all existing and future regulations applicable to employees of the Company and to the Company's business.

ARTICLE II
DUTIES OF EMPLOYEE

2.1. General Duties. Employee shall serve as the President and Chief Executive Officer of the Company. In his capacity as President and Chief Executive Officer, Employee shall do and perform all services, acts, or other things necessary or advisable to manage and conduct the business of the Company, including, but not limited to, the supervision, direction, and control of the business and other employees of the Company, subject to the policies and direction of the Board. Employee shall have all powers, duties, and responsibilities necessary to carry out his duties, and such other powers and duties as the Board may prescribe consistent with the Company's articles and bylaws. Employee may work one day per week from his home.

2.2. Exclusive Services. It is understood and agreed that Employee may not engage in any other business activity during the term of his employment hereunder, whether or not for profit or other remuneration, without the prior written consent of the Company. Further, Employee shall not directly or indirectly acquire any stock or interest in any corporation, partnership, or other business entity that competes, directly or indirectly, with the business of the Company.

2.3. Reporting Obligations. In connection with the performance of his duties hereunder, unless otherwise instructed by the Company's Board, the Employee shall report directly to the Board.

2.4. Director. Employee shall also serve as a director of the Company, and shall be nominated as director each year subject to continued approval of the stockholders of the Company as required by law.

ARTICLE III
COMPENSATION AND BENEFITS OF EMPLOYEE

3.1. Annual Base Salary. The Company shall pay the Employee salary for the services to be rendered by him during the term of this Agreement at the rate of two hundred thousand dollars ($200,000) per annum for the period between January 1, 2000 to December 31, 2000, with any difference between the annual base salary and amount actually received by Employee to be temporarily deferred, subject to this provision and Section 4.3 hereof. Thereafter, the Employee's annual base salary shall be as determined by the Company's Compensation Committee, subject to Board approval, on an annual basis, but in no event shall such annual base salary be less than two hundred thousand dollars ($200,000) per annum. Such annual base salary shall be payable in periodic installments in accordance with the terms of the Company's regular payroll practices in effect from time to time during the term of this Agreement, but in no event less frequently than once each month. Any amounts voluntarily deferred by Employee during the term of this Agreement may be paid to Employee from time to time at such times as the Board and Employee agree the Company is financially able to make such payments. All deferred compensation shall accrue simple interest at the rate of six percent (6%) per annum from the date of actual deferment.

3.2. Bonuses. In addition to the Employee's base salary and other benefits provided to Employee hereunder, Employee shall be eligible to receive bonuses based on Company performance and Employee's attainment of objectives established annually by the Compensation Committee of the Board of Directors.

3.3. Stock Options. Unless this Agreement has been previously terminated, on the first business day of January of each year during the Employment Term (including on the Effective Date stated above), Employee shall be granted immediately vesting stock options to purchase 100,000 shares of the Company's common stock at an exercise price equal to the lower of (i) the closing price of the common stock as of the first business day of January, or
(ii) the average closing price of the common stock for the first six months of the year. The stock options may be subject to (a) the further terms and conditions set forth in the Company's 1996 Stock Option Plan and 1998 Stock Option Plan, as they may be amended or updated from time to time or other stock option plans that may be adopted, and the Stock Option Agreement required to be executed thereunder, and (b) the Employee's execution of all documents customarily required by the Company to effect the grant of options.

3.4. Expenses. The Company shall pay or reimburse the Employee for all reasonable, ordinary, and necessary business expenses actually incurred or paid by Employee in the performance of Employee's services under this Agreement in accordance with the expense reimbursement policies of the Company in effect from time to time during the Employment Term, upon presentation of proper expense statements or vouchers or such other written supporting documents as the Company may reasonably require.

3.5. Vacation. Employee shall be entitled to four (4) weeks paid vacation for each calendar year (prorated for any portion of a year, as applicable), such vacation to accrue at the rate of thirteen and one-third
(13.33) hours per month. Notwithstanding anything to the contrary in this Agreement, vacation time shall cease to accrue beyond eight (8) weeks at any given time during the Employment Term.

3.6. General Employment Benefits. Except where expressly provided for herein, Employee shall be entitled to participate in, and to receive the benefits under, any pension, health, life, accident, and disability insurance plans or programs and any other employee benefit or fringe benefit plans that the Company makes available generally to its employees, as the same may be in effect from time to time during the Employment Term.

3.7. Indemnification. Consistent with the terms of the Company's articles and bylaws, the Company shall indemnify and hold Employee harmless for any actions taken or decisions made by him in good faith while performing services in his capacity as President and Chief Executive Officer of the Company during the Employment Term.

3.8. Annual Physical. Employee shall have the right to an annual physical examination at the cost of the Company.

ARTICLE IV
TERMINATION OF EMPLOYMENT

4.1. Termination. This Agreement may be terminated as provided for in this Article IV, or extended by further written agreement of the parties.

4.2. Termination For Cause. The Company reserves the right to terminate this Agreement for cause upon: (a) Employee's willful and continued failure to substantially perform his duties with the Company (other than such failure resulting from his incapacity due to physical or mental illness) after there is delivered to Employee by the Board, acting reasonably and in good faith, a written demand for substantial performance which sets forth in detail the specific respects in which the Board believes Employee has not performed his duties, and giving Employee not less than thirty (30) days to correct the deficiencies specified in the written notice; (b) Employee's willful engagement in gross misconduct as determined by the Board which is materially and demonstrably injurious to the Company; or (c) Employee's commission of a felony, or an act of fraud against the Company or its affiliates. Upon termination for cause, Employee shall not be entitled to any severance benefits.

4.3. Termination Without Cause. Notwithstanding anything to the contrary in this Agreement, the Company reserves the right to terminate this Agreement at any time without cause, subject to the express terms and provisions below.

If Employee is terminated without cause, then on such date (the "Termination Date"), the Employee-Employer relationship will cease and Employee will be entitled to receive in one lump-sum: (a) three times (3X) the Employee's base annual salary for the immediately previous full fiscal year, and (b) any amounts deferred during the term of this Agreement. Employee, at his sole discretion, may be entitled to apply any and all such amounts directly to the exercise price of any stock options then held by him.

If Employee is terminated without cause, then to the extent not already granted, the remaining options to be granted on the first business day in January of each year during the Employment Term shall be granted as of the Termination Date with an exercise price equal to the lowest closing price of a share of common stock as of (i) the first business day in January; (ii) the Termination Date; or (iii) the average bid price between the period from the first business day in January until the Termination Date provided that the Termination Date is a date less than six (6) months of the Employment Year. Such option shall have an exercise period of ten (10) years from the Termination Date.

4.4. Voluntary Termination by Employee. Notwithstanding anything to the contrary in this Agreement, Employee may terminate this Agreement at any time upon ninety (90) days written notice to the Company, or upon written notice delivered prior to December 1st if Employee does not intend to renew this Agreement for an additional one-year term. If Employee voluntarily terminates employment, Employee shall not be entitled to any severance benefits, but will be entitled to receive all deferred compensation and any other benefits required by law.

4.5. Change in Control; Severance. If there is a "change in control" in the Company during the Employment Term, then this Agreement shall be terminated, effective as of the date the change in control. For the purposes of this Section 4.5, a "change in control" shall mean an event involving one transaction or a related series of transactions, in which: (a) the Employer issues securities equal to fifty percent (50%) or more of the issued and outstanding capital stock of the Employer to any individual, firm, partnership, or other entity, including a "group" within the meaning of Section 13 (d)(3) of the Securities Exchange Act of 1934 ("the Exchange Act"); (b) the Employer is acquired in a merger or other business combination in which the Employer is not the surviving corporation; or
(c) fifty percent (50%) or more of the Employer's consolidated assets or earning power are sold or transferred. In the event of a change in control, Employee, upon the effective date of the change in control, shall be paid, in one payment, the sum of six (6) times Employee's annual base salary for the fiscal year preceding the announcement of the change in control. Further, upon a change in control, any option to be issued to Employee will be treated as if there was termination without cause under Section 4.3.

4.6. Gross-up Payment. If the Employee becomes subject to the excise tax imposed by Section 4999 of the Internal Revenue Code of 1986, as amended (the "Code") on "excess parachute payments" as defined in Section 280G of the Code or the Employee incurs any interest or penalties with respect to such excise tax (such excise tax, together with any such interest or penalties, being hereinafter collectively referred to as the "Excise Tax"), the Employer shall be obligated to promptly pay to the Employee that amount that is necessary to place the Employee in the same after-tax (taking into account all federal, state, local, and other taxes) financial position that the Employee would have been in if he had not incurred any tax liability under Section 4999 of the Code or otherwise relating to the Excise Tax.

4.7. Disability. If Employee becomes permanently and totally disabled, this Agreement shall be terminated. Employee shall be deemed permanently and totally disabled if he is unable to engage in the activities required by this Agreement by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than three (3) months. If this Agreement is terminated due to Disability, Options then held as of the date of Disability may be exercised by the Optionee or the Employee's personal representative in whole or in part, at any time within one year after the Disability. In addition, the Company shall purchase disability insurance in an amount such that in the event the Employee is disabled in accordance with this Section 4.7, the insurance proceeds will be equal to the amount that Employee would have received, net of taxes, under the remaining term of this Employment Agreement.

4.8. Death. If Employee dies during the term of this Agreement, this Agreement shall be terminated on the last day of the calendar month of his death subject to the express terms and provisions below.

Upon the death of Employee, all unexercised options which have been granted as of the date of death may be exercised by the designated beneficiary, as provided in Section 6.8 below, the estate, or Employee's personal representative in whole or in part within one year of the date of death. The Company shall provide Employee with life insurance, at Company's expense, in an amount equal to one million dollars ($1,000,000).

4.9. Effect of Termination. Except as expressly provided for in this Agreement, the termination of employment shall not excuse any obligation that accrued prior to termination, nor shall termination excuse the performance of any obligation which is required to be performed after termination. Any such obligation shall survive the termination of employment and this Agreement.

ARTICLE V
COVENANTS AND REPRESENTATIONS OF EMPLOYEE

5.1. Unfair Competition. Employee acknowledges that he will have access at the highest level to, and the opportunity to acquire knowledge of, the Company's customer lists, customer needs, business plans, trade secrets, and other confidential and proprietary information from which the Company may derive economic or competitive advantage, and that he is entering into the covenants and representations in this Article V in order to preserve the goodwill and going concern value of the Company, and to induce the Company to enter into this Agreement. Employee agrees not to engage in any unfair competition with Company. In addition during the Employment Term and the term of any consulting agreement, if applicable, Employee will not work or assist directly or indirectly with a competitor of Employer.

5.2. Confidential Information. During the Employment Term and at all times thereafter, the Employee agrees to keep secret and to retain in the strictest confidence all confidential matters which relate to the Company or its "affiliate" (as that term is defined in the Exchange Act), which are of a specific nature to the Company's business and not generic skills or knowledge of Employer, and which may include, but not necessarily be limited to, customer lists, client lists, trade secrets, pricing lists, business plans, financial projections and reports, business strategies, internal operating procedures, and other confidential business information from which the Company derives an economic or competitive advantage, or from which the Company might derive such advantage in its business, whether or not labeled "secret" or "confidential."

5.3. Non-Solicitation of Customers. During the Employment Term, the Employee will have access to confidential records and data pertaining to the Company's customers, their needs, and the relationship between the Company and its customers. Such information is considered secret and is disclosed during the Employment Term in confidence. Accordingly, during the later of the end of the Employment Term and one year thereafter or during a consulting agreement, if applicable, the Employee and any entity controlled by him or with which he is associated (as the terms "control" and "associate" are defined in the Exchange Act) shall not, directly or indirectly (i) solicit for a competitive purpose, interfere with, induce or entice away any person or entity that is or was a client, customer or agent of the Company or its affiliate (as the term "affiliate" is defined in the Exchange Act), or (ii) in any manner persuade or attempt to persuade any such person or entity (A) to discontinue its business relationship with the Company or its affiliate, or (B) to enter into a business relationship with any other entity or person the loss of which the Employee should reasonably anticipate would be detrimental to the Company or its affiliate in any respect.

5.4. Non-Solicitation of Employees. The Employee and any entity controlled by him or with which he is associated (as the terms "control" and "associate" are defined in the Exchange Act shall not, during later of the end of the Employment Term and for one (1) year thereafter or end of the consulting agreement, if applicable, directly or indirectly solicit, interfere with, hire, offer to hire or induce any person who is or was an officer or employee of the Company or any affiliate (as the term "affiliate" is defined in the Exchange Act) (other than secretarial personnel) to discontinue his relationship with the Company, or affiliate of the Company, in order to accept employment by, or enter into a business relationship with, any other entity or person. (These acts are hereinafter referred to as the "prohibited acts of solicitation.") The foregoing restriction, however, shall not apply to any business with which Employee may become associated after the Employment Term so long as the prohibited acts of solicitation taken by such business are not as a result of the active participation or involvement, direct or indirect, by the Employee.

5.5. Return of Property. Upon termination of employment, and at the request of the Company otherwise, the Employee agrees to promptly deliver to the Company all Company or affiliate memoranda, notes, records, reports, manuals, drawings, designs, computer files in any media, and other documents (including extracts and copies thereof) relating to the Company or its affiliate, and all other property of the Company.

5.6. Inventions. All processes, inventions, patents, copyrights, trademarks, and other intangible rights that may be conceived or developed by the Employee, either alone or with others, during the Employment Term and consulting agreement, if applicable, whether or not conceived or developed during Employee's working hours, and which are related to the Company's business, shall be the sole property of the Company. Employee shall execute all documents, including patent applications and assignments, required by the Company to establish the Company's rights under this provision.

5.7. Representations. The Employee represents and warrants to the Company that he has full power to enter into this Agreement and perform his duties hereunder, and that his execution and delivery of this Agreement and the performance of his duties shall not result in a breach of, or constitute a default under, any agreement or understanding, whether oral or written, including, without limitation, any restrictive covenant or confidentiality agreement, to which he is a party or by which he may be bound.

ARTICLE VI
MISCELLANEOUS PROVISIONS

6.1. Notices. All notices to be given by either party to the other shall be in writing and may be transmitted by personal delivery, facsimile transmission, overnight courier or mail, registered or certified, postage prepaid with return receipt requested; provided, however, that notices of change of address or telex or facsimile number shall be effective only upon actual receipt by the other party. Notices shall be delivered at the following addresses, unless changed as provided for herein.

To the Employee:	Robert O. Smith 5148 Felter Road San Jose, CA 95132
To the Company:	Attention: Secretary Digital Power Corporation 41920 Christy Street Fremont, CA 94538-3158

6.2. No Assignment. This Agreement, and the rights and obligations of the parties, may not be assigned by either party without the prior written consent of the other party.

6.3. Applicable Law. This Agreement and the relationships of the parties in connection with the subject matter of this Agreement shall be governed by, and construed under, the laws of the State of California.

6.4. Entire Agreement. This Agreement supersedes any and all other agreements or understandings of the parties, either oral or written, with respect to this employment of Employee by the Company, and contains the complete and final agreement and understanding of the parties with respect thereto. Employee acknowledges that no representation, inducements, promises, or agreements, oral or otherwise, have been made by the Company or any of its officers, directors, employees or agents, which are not expressed herein, and that no other agreement shall be valid or binding on the Company.

6.5. Withholding Taxes. All amounts payable under this Agreement, whether such payment is to be made in cash or other property, including, without limitation, stock of the Company, may be subject to withholding for Federal, state, and local income taxes, employment and payroll taxes, and other legally required withholding taxes and contributions to the extent appropriate in the determination of the Company, and the Employee agrees to report all such amounts as ordinary income on his personal income tax returns and for all other purposes, as called for.

At the election of Employee, Employee shall have the right to sell to the Company any vested stock options (at the then fair market value of the common stock less the exercise price) in order to meet any withholding requirements or pay income taxes on income related to such options.

6.6. Severability. If any provision of this Agreement is held to be invalid or unenforceable by any judgment of a tribunal of competent jurisdiction, the remaining provisions and terms of this Agreement shall not be affected by such judgment, and this Agreement shall be carried out as nearly as possible according to its original terms and intent and, to the full extent permitted by law, any provision or restrictions found to be invalid shall be amended with such modifications as may be necessary to cure such invalidity, and such restrictions shall apply as so modified, or if such provisions cannot be amended, they shall be deemed severable from the remaining provisions and the remaining provisions shall be fully enforceable in accordance with law.

6.7. Effect of Waiver. The failure of either party to insist on strict compliance with any provision of this Agreement by the other party shall not be deemed a waiver of such provision or a relinquishment of any right thereunder, nor shall it affect the validity of this Agreement nor prevent enforcement of such provision or any similar provision, at any time.

6.8. Designation of Beneficiary. If the Employee shall die before receipt of all payments and benefits to which he is entitled under this Agreement, payment of such amounts or benefits in the manner provided herein shall be made to such beneficiary as he shall have designated in a writing that is filed with the Secretary of the Company or, in the absence of such designation, to his estate or personal representative.

6.9. Arbitration. Any controversy between Employer and Employee involving the construction or application of any of the terms, provisions, or conditions of this Agreement shall be submitted to arbitration. Arbitration shall comply with and be governed by the provisions of the American Arbitration Association.

6.10. Attorneys Fees. In the event of any litigation arising out of this Agreement, or the parties' performance as outlined herein, the prevailing party shall be entitled to an award of costs, including an award of reasonable attorney's fees.

6.11. Counterparts. This Agreement may be executed in one or more counterparts, each of which when taken together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties have executed and delivered this Agreement as of the date first above written.

EMPLOYER

DIGITAL POWER CORPORATION,
A California Corporation

By: ______________________________________
Scott C. McDonald, as Director and Member of Compensation Committee on behalf of the Company

By: ______________________________________
Thomas W. O'Neil, Jr., as Director and Member of Compensation Committee on behalf of the Company

EMPLOYEE

By: ______________________________________
Robert O. Smith,

President and Chief Executive Officer

ARTICLE 5

(Replace this text with the legend)

PERIOD TYPE	12 MOS
FISCAL YEAR END	DEC 31 1999
PERIOD START	JAN 01 1999
PERIOD END	DEC 31 1999
CASH	824,708
SECURITIES	0
RECEIVABLES	2,813,080
ALLOWANCES	210,485
INVENTORY	4,531,261
CURRENT ASSETS	8,761,374
PP&E	1,223,137
DEPRECIATION	500,691
TOTAL ASSETS	11,160,833
CURRENT LIABILITIES	3,393,457
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	9,012,679
OTHER SE	(1,360,472)
TOTAL LIABILITY AND EQUITY	11,160,833
SALES	15,354,018
TOTAL REVENUES	15,354,018
CGS	11,277,170
TOTAL COSTS	3,756,183
OTHER EXPENSES	6,236
LOSS PROVISION	0
INTEREST EXPENSE	178,343
INCOME PRETAX	150,191
INCOME TAX	123,000
INCOME CONTINUING	27,191
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	27,191
EPS BASIC	.01
EPS DILUTED	.01

End of Filing