DIGITAL POWER CORP
Form 10KSB
April 01, 2002

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, 2001

[ ] 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, 2001, were $10,329,857.

As of March 15, 2002, the aggregate market value of the voting common stock held by non-affiliates was approximately $2,804,185 based on the closing price of $0.80 per share.

As of March 15, 2002, the number of shares of common stock outstanding was 4,510,680.

Documents Incorporated by reference. The information required by Items 9, 10, 11, and 12 of Part III are incorporated by reference to the Company's proxy statement which will be filed within 120 days of the registrant's year end.

Transitional Small Business Disclosure Format (check one): Yes No |X|

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With the exception of historical facts stated herein, the following discussion may contain forward-looking statements regarding events and financial trends which may affect Digital Power's future operating results and financial position. Such statements are subject to risks and uncertainties that could cause Digital Power'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 fact that we have experienced substantial losses from our operations, dependence on the computer and electronic equipment industries, competition in the power supply industry, and expenses related to the operation of our Guadalajara, Mexico facility, 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. Digital Power's disclaims any intent or obligation to publicly update these "forward looking" statements, whether as a result of new information, future events, or otherwise.

As used in this annual report, the terms "we," "us," "our," the "Company," "Digital" or "Digital Power" mean Digital Power Corporation and its subsidiaries unless otherwise indicated.

PART I.

Item 1. Description of Business

General

We are a California corporation originally formed in 1969. Our corporate office is located in Fremont, California. We have a manufacturing facility in Guadalajara, Mexico, and a design, manufacturing, and sales facility in Salisbury, England. We design, develop, manufacture, and sell 50 watt to 750 watt switching power supplies and DC/DC converters to original equipment manufacturers ("OEMs") of computers and other electronic equipment. Through our subsidiary Digital Power Limited, we also design, manufacture and sell uninterruptible power supplies, power conversion and distribution equipment for naval and military applications and DC/AC inverters primarily for the telecommunications industry in Europe under the label Gresham Power Electronics.

We primarily sell our power supplies to the computer and telecommunications industries. Both in the United States and Europe, these industries have experienced reductions in sales which have adversely affected our operations and financial condition. As a result, we experienced a cash shortage and incurred substantial losses during the year ended December 31, 2001. To obtain working capital, we entered into a securities purchase agreement with Telkoor Telecom Ltd., an Israeli company. Under the terms of the securities purchase, Telkoor Telecom invested $1,250,000 in us in exchange for 1,250,000 shares of our common stock and warrants to purchase 1,900,000 shares of our common stock. This transaction resulted in a change in control of our management and board of directors.

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.

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Power supplies satisfy these issues of allocation and protection by (i) converting alternating current (AC) electricity into DC; (ii) by dividing a single input voltage into distinct and isolated output voltages; and (iii) 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 the 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. Our switching power supply products have a high power density and are generally smaller than those of competitors. For example, to the best of our knowledge our US100 series of power supplies, when originally introduced on a 3"x 5" printed circuit board, was the smallest 100 watt off-line (AC input) power supply available in the industry.

Another advantage of our power supply products is the extreme flexibility of design. We have designed the 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 us 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." This "flexibility" approach also results in very low non-recurring engineering (NRE) expenses. Because of reduced NRE expenses, we do not charge our OEM customers for NRE related to tailoring a power supply to a customer's specific requirements. This gives us a distinct advantage over our competitors, many of whom do charge their customers for NRE expenses. Our 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, we also provide "value-added services." The term "value-added services" refers to our incorporation of an OEM's selected electronic components, enclosures, and cable assemblies with our power supply products to produce a power subassembly that is compatible with the OEM's own equipment and specifically tailored to meet the OEM's needs. We purchase parts and components that the OEM itself would otherwise attach to or integrate with our power supply, and we provide the OEM with that integration and installation service, thus saving the OEM time and money. We believe that this value-added service is well-suited to those OEMs who wish to reduce their vendor base and minimize their investment in manufacturing which leads to increased fixed costs. Based on the value-added services, the OEMs do not need to build assembly facilities to manufacture their own power subassemblies and thus are not required to purchase individual parts from many vendors.

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We are a California corporation originally formed in 1969 through a predecessor. Unless the context indicates otherwise, any reference to "Digital Power" herein includes our wholly-owned Mexican subsidiary, Poder Digital S.A. de C.V. and our wholly-owned United Kingdom subsidiary, Digital Power Limited, dba Gresham Power Electronics. Further, unless otherwise indicated, reference to dollars in this report shall mean United States dollars.

Telkoor Telecom Ltd.

On November 20, 2001, we completed a securities purchase agreement with Telkoor Telecom. Under the securities purchase agreement, Telkoor Telecom acquired (i) 1,250,000 shares of common stock (ii) a warrant to purchase an additional 900,000 shares of common stock at $1.25 per share; and (iii) a warrant to purchase an additional 1,000,000 shares of common stock at $1.50 per share for the aggregate purchase price of $1,250,000. The 900,000 share warrant will expire sixty (60) days after the Company files its Form 10-KSB for the year ending December 31, 2002, and the 1,000,000 share warrant will expire on December 31, 2003.

Further, pursuant to the securities purchase agreement, Telkoor Telecom has the right to appoint a majority of the Board of Directors. The Board of Directors now consists of Mr. Ben-Zion Diamant, Chairman of the Board, Mr. David Amitai, Mr. Mark L. Thum, Mr. Robert O. Smith and Mr. Josef Berger. Mr. Amitai has also been appointed as President and Chief Executive Officer, and Mr. Uri Friedlander has been appointed Chief Financial Officer. Mr. Robert Smith, the Company's previous President and Chief Executive Officer serves as a consultant to the Company.

Telkoor Telecom is primarily engaged in developing, marketing and selling power supplies and power systems for the telecommunication equipment industry. It hoped that we will be able to utilize Telkoor Telecom's engineering expertise to assist us in the development of our products. Further, we would like to offer Telkoor Telecom's products in the United States and we are hopeful that we will be able to sell our products through Telkoor Telecom. Telkoor Telecom used its own funds to purchase the securities. Telkoor Telecom's initial investment of 1,250,000 shares represents approximately 28% of the outstanding shares, with the right to increase their ownership to 49% assuming all of the warrants are exercised.

Digital Power Limited

In 1998, we acquired the assets of Gresham Power Electronics. Headquartered in Salisbury, England, Digital Power Limited designs, manufactures, and distributes switching power supplies, uninterruptible power supplies, and frequency converters for the commercial and military markets under the name Gresham Power Electronics. 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 converters manufactured by Digital Power Ltd. are used to convert a warship's generated 60 cycle electricity supply to 400 cycles. This 400 cycle supply is used to power critical equipment such as the ship's gyro, compass and weapons systems. The acquisition of Gresham Power Electronics has diversified our product line, provided greater access to the United Kingdom and European

markets, and strengthened our engineering and technical resources. For the year ended December 31, 2001, Digital Power Limited contributed approximately 37% to our gross revenues.

The Market

Since virtually 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. However, since the middle of year 2000, the power supply industry has experienced a substantial decrease in sales due to the overall decline in the electronic equipment industry.

The electronic power supply market is typically split into "captive" and "merchant" market segments. The captive segment of the market is 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.

We believe that the merchant market is the more favorable segment of the power supply market, as OEMs are expected to continue to outsource their power supply requirements. We believe that this 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 the "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 ten 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.

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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. We have targeted and serve the industrial and office automation, industrial and portable computing, and networking applications niches of the merchant market. We believe that our focus on high-efficiency, high-density, design-flexible power supplies is ideally suited to the rapid growth opportunities existing in this market segment.

Geographically, we primarily serve 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. Digital Power Ltd. serves the United Kingdom and the European marketplace with AC/DC power supplies, uninterruptible power supplies, and frequency inverters. Both commercial and government (Ministry of Defense) markets are served by Digital Power Ltd.

Customers

Our products are sold domestically and in Canada through a network of 14 manufacturers' representatives. We also have 19 stocking distributors in the United States and Europe. In addition, we have formed strategic relationships with one of our customers to private label our products. Our customers can generally be grouped into three broad industries, consisting of the computer, telecommunication, and instrument industries. We have a current base of over 150 active customers, including companies such as Telex, Dot Hill, Motorola, Extreme Networks, Foundry Networks, JDS Uniphase, Ericsson, British Telecom and Lucent.

Gresham Power Electronic products are sold primarily in the United Kingdom and to a lesser extent in Europe. Our customers in Europe include the United Kingdom Ministry of Defense, Vosper Thorney Croft, Emerson and Seimens.

Strategy

Our 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, we do 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.

We intend to continue our sales primarily to existing customers while simultaneously targeting sales to new customers. We believe that our "flexibility" concept allows customers a unique choice between our 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 OEM customers a new choice with Digital Power "flexibility" series, we believe we have an advantage over our competitors. Our "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 and higher efficiency. Digital Power's strategy in responding to this demand has been to offer increasingly smaller power supply units or packages.

Product Strategy and Products

We have ten 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 2.0 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. Our US100 series is an example of a product using this manufacturing technology.

Digital Power's "flexibility" concept applies to all of our US, UP/SP, DP and UPF 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 our 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 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. We also offer 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".

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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 or 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 our 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 EN 61000-3-2. 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.

Two of our newer products are the UPF 150 and UPF 300 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. Also incorporating active power factor correction, the UPF 300 delivers up to 300 watts from one or two outputs and measures 8" x 4.5" x 2".

We also offer our customers various types of value-added services, which may include the following additions to their standard product offerings:

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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 our 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, we use no custom components.

Gresham Power Electronics' primary product lines include the following:

Military Power Supplies. Design and manufacture of AC and DC power conversion equipment which is intended for naval and other applications where arduous duties demand quality and reliability. Products include transformer rectifier units to 15KVA and Static Frequency Converters to 5KVA.

Commercial Component Power Supplies. Distribution and service of all Digital Power's product lines to non-American markets.

Uninterruptible Power Supplies. Distribution and service of uninterruptible power supplies mainly to the United Kingdom telecommunications industry. Products offered range from 250VA to 100KVA but main market is up to 10KVA.

Telecommunications Inverters. Design and manufacture of DC to AC sine-wave inverters. Rugged equipment intended for use in remote areas for the support of mobile telecommunications installations.

Through our relationship, we intend to sell certain products currently offered by or under development by Telkoor Telecom. These products include the Telkoor Telecom's CompactPCI family of products and the eF 175 and eF 306 power supplies currently under development. The CompactPCI products are high density, high efficiency, and unique form factor power supplies for the CompactPCI - standard platforms, telecommunication hubs, high reliability servers and redundant power systems applications. The eF175 and eF 306 are currently under development and are anticipated to replace our UPF 150 and 300 series.

Manufacturing Strategy

Consistent with our product flexibility strategy, we aim to maintain a high degree of flexibility in our manufacturing processes in order to respond to rapidly changing market conditions. 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, we believe that our flexible manufacturing strategy is best achieved

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through a highly variable cost of operation. In 1986, we established a wholly owned subsidiary in Guadalajara, Mexico to assemble our products. This manufacturing facility performs materials management, sub-assembly, final assembly, and test functions for the majority of our power supply products. Currently, almost all of our manufacturing, including our value-added services, is done at a 16,000 square foot facility operated by our wholly owned subsidiary, Poder Digital, S.A. de C.V., located in Guadalajara, Mexico.

During the year ended December 31, 2001, our operating costs at the Guadalajara, Mexico ("Mexico") manufacturing facility exceed our revenues. As a result we took steps to reduce these operating costs including the lay off of a number of workers. During 2001, we experienced charges of $658,000 related to the severance of employees in Mexico. Currently, we have production over capacity in Mexico. Although we intend to lay off more employees in Mexico, under Mexican law, employees are entitled to severance pay if they are laid off. At this time, we do not have sufficient funds to pay the severance cost to further reduce our operating cost in Mexico. We are continuing to analyze our operations in Mexico in order to determine ways to further reduce our costs.

In addition, we have a vendor relationship with Fortron/Source Corp. to manufacture our 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. We are manufacturing approximately 8.30% of our product requirements through Fortron/Source and expect to increase these production levels due to cost advantages achieved through Chinese procurement.

Digital Power Limited Manufacturing

Digital Power Limited is ISO9001-1 certified and operates from a 25,000 sq. ft leased facility located in Salisbury U.K.

The products manufactured in Salisbury are physically different from those produced in Mexico, but the factory is organized on similar lines; where all procurement of component parts is out-sourced with only final assembly, test and quality assurance taking place in-house.

Sales and service support staff for the European network of distributors for Digital Power products are located within the building together with other functions such as Engineering and Administration. The company operates a fully integrated production control and accounting system.

Sales, Marketing and Customers

During 2001, we had revenues of $10,329,857 and net loss of $7,040,720 compared to revenues of $17,882,730 and net income of $95,167 during fiscal year 2000.

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 we or the representative organization may terminate the agreement with 30 day's written notice.

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In certain territories, we have entered into agreements with 20 domestic and 11 international stocking distributors who buy and resell our products. For the fiscal years ended December 31, 2001 and 2000, domestic distributor sales accounted for 16.15% and 31.6%, respectively, of our total sales. Over this same period, one distributor accounted for 12.62%, and 11.6%, respectively, of total sales. In addition, international sales through stocking distributors accounted for less than 2.36% of our 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 us, we believe that we would be able to continue the sale of our 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.

We have also entered into agreements with one private label customer who buy and resell our products. Under these agreements, we sell our products to the private label company who then resells the products with its label to its customers. We believe that these private label agreements expand our market by offering the customer a second source for our 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, 2001 and 2000, private label sales accounted for 2.39% and 3.1%, respectively, of total sales.

Our promotional efforts to date have included product data sheets, feature articles in trade periodicals, trade shows and Internet Web sites. Our 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.

Our 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 2001 or 2000. As of December 31, 2001 and 2000, our warranty reserve was $201,094 and $324,602, respectively.

Competition

The merchant power supply manufacturing industry is highly fragmented and characterized by intense competition. Our competition includes over 500 companies located throughout the world, some of whom have advantages over us in terms of labor and component costs, and some of whom may offer products comparable in quality to ours. Many of our competitors, including PowerOne, Artesyn Technologies, Inc., ASTEC America, Lambda Electronics, and American Power Conversion have substantially greater fiscal and marketing resources and geographic presence than we do. If we are successful in increasing our revenues, competitors may notice and increase competition for our customers. We also face 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 us if consolidation trends in the electronics industry continue and some of the OEMs to whom we sell our products are acquired by larger OEMs. To remain competitive, management believes that we 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. We believe we have a competitive position with our targeted customers who need a high-quality, compact product which can be readily modified to meet the customer's unique

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requirements. However, there can be no assurance that we will continue to compete successfully in the power supply market.

Research and Development

Our 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 we attempt 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 our products. Product development is performed at our headquarters in California by two engineers who are supported and assisted by four technicians. Our total expenditures for research and development were $1,065,872 and $1,166,015 for the years ended December 31, 2001 and 2000, respectively, and represented 10.32% and 6.52% of our total revenues for the corresponding periods.

Employees

As of December 31, 2001, we had approximately 177 full-time employees, with 120 of these employed at our wholly-owned subsidiary Poder Digital located in Guadalajara, Mexico, and 29 employed by Digital Power Ltd. The employees of Digital Power's Mexican operation are members of a national labor union, as are most employees of Mexican companies. We have not experienced any work stoppages at any of our facilities and believe that our employee relations are good.

Guadalajara, Mexico Facility and Foreign Currency Fluctuations

We produce substantially all of our products at our 16,000 square foot facility located in Guadalajara, Mexico. The products are then delivered to Fremont, California for testing and distribution. We believe that we have a good working relationship with our employees in Guadalajara, Mexico and have recently signed a five-year contract with the union representing the employees. In 1997, we entered into a "turnkey" manufacturing contract with a manufacturer located in China to produce our products in an attempt to reduce our dependence on our Mexican facility. At this time the purchase of products from the manufacturer located in China accounts for approximately 8.30% of revenues and requires advance scheduling which affects our ability to produce products quickly. However, if our revenues grow as anticipated, we intend to manufacture more of our 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 our ability to deliver our products and may adversely affect our 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 our control, we are subject to monetary fluctuations between the U.S. dollar, Mexican peso, and United Kingdom pound.

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RISK FACTORS

In addition to the other information presented in this report, the following should be considered carefully in evaluating us and our business. This report contains various forward-looking statements that involve risks and uncertainties. Our 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.

We experience a net loss during the year ended December 31, 2001, and anticipate that losses will continue in the near future.

For the year ended December 31, 2001, we incurred a net loss of $7,040,720. We have actively taken steps to reduce our costs. Although our future losses may not be of the same magnitude as last year, we will continue to incur a net loss in the near future until our revenues increase through the sale of current products and new products under development.

We are experiencing a cash shortage.

As a result of a substantial decrease in sales, we are currently experiencing a cash shortage. In order to decrease our expenses, we have laid off employees. Further, in order to conserve cash we have delayed payments to our vendors and have requested discounts. Although some vendors have complied with our requests, there are some vendors who do not agree with these requests. No assurance can be given that some of our vendors may not bring litigation to collect their bill.

We are dependent on a limited number of customers.

Traditionally, we have relied on a limited number of customers for growth in sales. It cannot be assured that we will be able to retain current customers, and the loss of any major OEM customer may have an adverse effect on our revenues.

We have entered into a $750,000 credit facility that is secured by all our assets.

We have a $750,000 line of credit pursuant to a promissory note agreement. This promissory note is secured by all of our assets. During the year ended December 31, 2001, we were in default under certain covenants of the credit facility. However, based on discussions with the bank and a subsequent investment by Telkoor Telecom, we are currently in compliance with the loan covenants. In the event we default under the promissory note, the bank may have the right to attach all of our assets which would adversely affect our operations.

DPL has a (pound)500,000 bank overdraft facility pursuant to a loan agreement. In the event that the bank overdraft facility is used, the loan would be collateralized by substantially all of the DPL's assets. At December 31, 2001, no principal or accrued interest was outstanding.

We are dependant on computer and other electronic equipment industries

Substantially all of our existing customers are in the computer and other electronic equipment industries and they manufacture products that are subject to rapid technological change, obsolescence, and large fluctuations in demand. These industries are further characterized by intense competition. The OEMs serving these markets are pressured for increased product performance and lower

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product prices. OEMs, in turn, make similar demands on their suppliers, such as us, for increased product performance and lower prices. The computer industry is inherently volatile. Recently, certain segments of the computer and other electronic industries have experienced a significant softening in product demand. Such lower demand may affect our customers, in which case the demand for our products may decline, and our growth could be adversely affected.

We are dependent on the performance of our facility in Guadalajara, Mexico and manufacturer in China; Foreign currency risks

Substantially all of the products sold by Digital Power in the United States are produced at our facility located in Guadalajara, Mexico. We also have a "turnkey" manufacturing contract with a manufacturer located in China to produce our products in an attempt to reduce our dependence on our Mexican facility. For the years ended December 31, 2001 and 2000, the purchase of products from our manufacturer located in China accounted for approximately 8.30% of our revenues.

We are dependant upon key personnel

Our performance is substantially dependent on the performance of its executive officers and key personnel, and on our ability to retain and motivate such personnel. The loss of any of our key personnel, particularly David Amitai, President and Chief Executive Officer, could have a material adverse effect on our business, financial condition and operating results.

We are dependant on suppliers

We rely on, and will continue to rely on, outside parties to manufacture parts, components and equipment. We cannot assure you that these suppliers will be able to meet our needs in a satisfactory and timely manner or that we will be able to obtain additional suppliers when and if necessary. A significant price increase, a quality control problem, an interruption in supply or other difficulties with third party manufacturers could have a material and adverse effect on our ability to successfully provide our products. Further, the failure of third parties to deliver the products, components, necessary parts or equipment on schedule, or the failure of third parties to perform at expected levels, could delay our delivery of power supply products.

Our products are not patentable

Our products are not subject to any U.S. or foreign patents. We believe that because our products are continually updated and revised, obtaining patents would be costly and not beneficial. Therefore, we cannot guarantee that other competitors or former employees will make use of and develop proprietary information on which we rely.

Our common stock price is volatile

Our common stock is listed on the American Stock Exchange and is thinly traded. In the past, our trading price has fluctuated widely, depending on many factors that may have little to do with our operations or business prospects.

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The exercise of outstanding options and warrants may adversely affect our stock price and your percentage of ownership

As of December 31, 2001, options to purchase 1,543,095 shares of common stock, with a weighted average exercise price of $1.74 exercisable at prices ranging from $0.70 to $6.25 per share were outstanding. In addition, we had warrants to purchase 1,900,000 shares of common stock at exercise prices ranging from $1.25 to $1.50 per share. The exercise of these options and warrants may have an adverse effect on the price of our common stock price and will dilute existing shareholder percentage ownership in the Company.

Item 2. Description of Properties.

Our headquarters are located in approximately 9,500 square feet of leased office, research and development space in Fremont, California. We paid $6,653 per month, subject to adjustment, and the lease expired on January 31, 2001. The

Fremont California lease was renewed until January 31, 2005, with monthly rent increasing to $11,875 over the next four years. Our manufacturing facility is located in 16,000 square feet of leased space in Guadalajara, Mexico. We pay approximately $4,583 per month, subject to adjustment, and the lease expired in February 2001. The Guadalajara, Mexico lease was renewed to January 31, 2003, with monthly rent increasing to $6,400. Gresham Power leases approximately 25,000 square feet for its location in Salisbury, England. Gresham Power pays rent of approximately (pound)20,100 per quarter, and the lease expires September 26, 2009. We believe that our existing facilities are adequate for the foreseeable future and have no plans to expand them.

Item 3. Legal Proceedings.

There currently are no legal proceeding pending involving the Company or its properties except for a lawsuit filed by the Company for the collection on an accounts receivable.

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

Our common stock is listed and traded on the American Stock Exchange ("AMEX") under the symbol DPW. The following tables set forth the high and low closing sale prices, as reported by AMEX, for our common stock for the prior two fiscal years.

	Common Stock	
Quarter Ended	High	Low
12/31/2001	$ 3.63	$1.25
9/30/2001	1.70	0.88
6/30/2001	1.21	0.59
3/31/2001	0.90	0.56

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	Common Stock	
Quarter Ended	High	Low
12/31/2000	6.63	1.50
9/30/2000	14.94	2.25
6/30/2000	3.63	2.00
3/31/2000	4.81	1.69

(b) Holders

As of March 15, 2002, there were 4,510,680 shares of our common stock outstanding, held by approximately 106 holders of record, not including shareholders whose shares are held in street name.

(c) Dividends

We have not declared or paid any cash dividends since our inception. We currently intend to retain future earnings for use in the operation and expansion of the business. We do 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 our earnings, capital requirements, and financial position.

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

General

We are engaged in the business of designing, developing, manufacturing, and marketing electronic power supplies for use in electronic circuitry. Revenues are generated from the sale of our power supplies to distributors, OEMs in the computer and other electronic equipment industries in the United States and Europe, and the defense industry in the United Kingdom.

During the fiscal year 2001, we experienced a significant slow down in customer orders in both the United States and Europe due to OEMs having excess inventories and softness in the marketplace. In response to the decrease in revenues, we have laid off employees in Fremont, California and Guadalajara, Mexico to reduce costs. In order to become more efficient and increase sales, we have hired a new chief operating officer and new sales officer. However, the current costs of our operations in Guadalajara, Mexico exceed our revenues. Until revenues increase to a sufficient amount to offset our expenses, we anticipate that we will continue to experience net losses for the near future.

Results of Operations

The table below sets forth certain statements of operations data as a percentage of revenues for the years ended December 31, 2001 and 2000:

	Years Ended December 31,	
	2001	2000
Revenues	100.00%	100.00%
Cost of goods sold	115.59	73.95
Gross margin (loss)	(15.59)	26.05
Research and development	10.32	6.52
Marketing and selling	8.36	7.54

	Years Ended December 31,	
	2001	2000
General and administrative	21.08	10.60
Impairment of goodwill	9.16	-
Total operating expense	48.92	24.66
Operating income (loss)	(64.51)	1.39
Net interest expense and other income	(0.76)	(0.28)
Income (loss) before income taxes	(65.27)	1.11

Provision for income taxes	2.89	0.58
Net Income (loss)	(68.16)%	0.53%

The following discussion and analysis should be read in connection with the consolidated financial statements and the notes thereto and other financial information included elsewhere in this report.

Year Ended December 31, 2001, Compared to Year Ended December 31, 2000

Revenues

For the year ended December 31, 2001, revenues decreased by 42.24% to $10,329,857 from $17,882,730 for the year ended December 31, 2000. The decrease in revenues during the year ended December 31, 2001, can be attributed primarily to the sudden and severe drop in demand by virtually every customer in the Company's markets in the United States and Europe.

Gross Margins

Gross margins were (15.59)% for the year ended December 31, 2001, compared to 26.05% for the year ended December 31, 2000. The decrease in gross margins can primarily be attributed to the excess capacity costs of the company's manufacturing operations in Guadalajara, Mexico, which resulted from the global slowdown in the electronics industry. While we took steps during the year to reduce this capacity through variable cost reductions, such as direct labor layoffs, many fixed costs associated with Poder Digital continued. In connection with the labor layoffs, we recognized a $658,000 severance charge that was included in cost of goods sold.

Also included in cost of goods sold was a provision for inventory obsolescence and excess of $2,714,941. The amount of the provision was originally higher during the second quarter as a result of rapidly diminishing sales and the cancellation of purchase orders by two of our customers. During the fourth quarter of 2001, we reversed approximately $395,781 of the inventory reserve. The reversal was based upon a fourth quarter analysis of inventory and future anticipated sales, and a partial resumption of purchase orders to two customers who had previously cancelled their orders.

In preparation for the downsizing of the Company's Mexican operations and the transition of more production to China, significant charges were taken for severance pay and obsolescence of inventory during the year. These charges had a significant year to date negative impact on the Company's gross margins.

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Engineering and Product Development

Engineering and product development expenses were 10.32% of revenues for the year ended December 31, 2001, compared to 6.52% for the year ended December 31, 2000. The increases in engineering and product development expenses reflect our continuing commitment to new product development.

Marketing and Selling

Marketing and selling expenses were 8.36% of revenues for the year ended December 31, 2001, compared to 7.54% for the year ended December 31, 2000. Although marketing and selling expenses were lower in terms of dollars in 2001, as a percentage they were higher in 2001 than 2000 due to a decrease in revenues in 2001.

General and Administrative

General and administrative expenses were 21.08% of revenues for the year ended December 31, 2001, compared to 10.60% for the year ended December 31, 2000. Staff reductions and salary cuts were implemented throughout 2001 in response to the reduced revenues. However, certain other expenses, such as legal and accounting, and Amex filing fees in connection with the Telkoor Telecom purchase resulted in higher total expenses, as a percentage of revenues.

Impairment of Goodwill

During the year, we recognized impairment change of $946,263 for goodwill associated with the purchase of the assets of Gresham Power due to their general decline in business and profitability.

Interest Expense

Interest expense, net of interest income, was 0.49% for the year ended December 31, 2001, compared to 0.34% for the year ended December 31, 2000. Under the terms of our line of credit, collections from accounts receivables are immediately applied to the outstanding balance of the line of credit. However, during the year 2001, we increased the borrowing on our line of credit, which was $652,261 at December 31, 2001.

Income Before Income Taxes

For the year ended December 31, 2001, we had a loss before income taxes of $6,741,837 compared to income of $199,167 for the year ended December 31, 2000.

Income Tax

The provision for income tax increased to $298,883 for the year ended December 31, 2001, from $104,000 for the year ended December 31, 2000. The company will continue to assess the realizability of the deferred tax assets in future periods. The valuation allowance increased by $4,049,459 during the year ended December 31, 2001. During March 2001, the Company fully valued the deferred tax asset recorded at December 31, 2000 of $350,523 due to the uncertainty of the Company's ability to recognize the benefit of the deferred tax asset of Digital Power in the future. The valuation allowance increased by $212,559 during the year ended December 31, 2000.

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Net Loss and Net Income

Net loss for the year ended December 31, 2001, was $7,040,720, compared to a net income of $95,167 for the year ended December 31, 2000. The net loss primarily resulted from the combined effects of the dramatic drop in revenues, excess manufacturing capacity and various inventory charges and write-offs as previously discussed.

Liquidity And Capital Resources

On December 31, 2001, we had cash of $1,242,900 and working capital of $1,867,959. This compares with cash of $806,407 and working capital of $6,461,665 at December 31, 2000. The decrease in working capital was mainly due to an increased allowance for obsolescence and excess inventories. The Company increased the allowance for obsolescence and excess inventories by approximately $2,715,000 which was a result of the cancellation of purchase orders by customers, excess inventory levels, lack of sales orders and delays in delivery of products by two customers. Cash provided (used in) operating activities totaled $(828,560) and $178,499 for the year ended December 31, 2001 and 2000.

Cash used in investing activities was $127,405 for the year ended December 31, 2001, compared to $149,947 for the year ended December 31, 2000. Net cash provided by (used in) financing activities was $1,457,602 for the year ended December 31, 2001, compared to $151,771, for the year ended December 31, 2000.

During the year, we had a $3 million revolving line of credit loan ("Revolving Loan") with San Jose National Bank, which Revolving Loan was secured by substantially all of our assets. Under the original terms of the Revolving Line, we could borrow against a percentage of accounts receivables and inventory. In August 2001, San Jose National Bank informed us that it we were in default of certain Revolving Loan covenants, including profitability, net worth amount and inventory amount. We subsequently met with San Jose National Bank and entered into a new Revolving Loan Agreement which set the maximum borrowing to $750,000. This revised Revolving Loan Agreement is subject to the same terms and conditions as the original Revolving Loan Agreement. We are currently in compliance with the covenants of the Revolving Loan Agreement.

On September 6, 2001, pursuant to the Securities Purchase Agreement, Telkoor Telecom advanced the Company $150,000. In addition, during October 2001, Telkoor Telecom lent the Company an additional $205,000 pursuant to a short-term convertible promissory note. The promissory note bears interest at 10% and was due upon the earlier of consummation of the Securities Purchase Agreement or December 31, 2001. The $205,000 loan was credited against the purchase price under the Securities Purchase Agreement. Under the Securities Purchase Agreement, Telkoor Telecom acquired (i) 1,250,000 shares of common stock (ii) a warrant to purchase an additional 900,000 shares of common stock at $1.25 per share; and (iii) a warrant to purchase an additional 1,000,000 shares of common stock at $1.50 per share for the aggregate purchase price of $1,250,000. The 900,000 share warrant will expire sixty (60) days after the Company files its Form 10-KSB for the year ending December 31, 2002 and the 1,000,000 share warrant will expire on December 31, 2003.

We do not believe that our sales are seasonal. Further, we do not believe that inflation will adversely affect our operations.

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Impact of Recently Issued Standards

Impact of Recently Issued Standards - In June 2001, the Financial Accounting Standards Board ("FASB") issued Statements of Financial Accounting Standards No. 141 "Business Combinations" ("SFAS 141") and No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for under the purchase method. For all business combinations for which the date of acquisition is after June 30, 2001, SFAS 141 also establishes specific criteria for the recognition of intangible assets separately from goodwill and requires unallocated negative goodwill to be written off immediately as an extraordinary gain, rather than deferred and amortized. SFAS 142 changes the accounting for goodwill and other intangible assets after an acquisition. The most significant changes made by SFAS 142 are: 1) goodwill and intangible assets with indefinite lives will no longer be amortized; 2) goodwill and intangible assets with indefinite lives must be tested for impairment at least annually; and 3) the amortization period for intangible assets with finite lives will no longer be limited to forty years. The Company does not believe that the adoption of these statements will have a material effect on its financial position, results of operations, or cash flows.

In June 2001, the FASB also approved for issuance SFAS 143 "Asset Retirement Obligations." SFAS 143 establishes accounting requirements for retirement obligations associated with tangible long-lived assets, including (1) the timing of the liability recognition, (2) initial measurement of the liability, (3) allocation of asset retirement cost to expense, (4) subsequent measurement of the liability and (5) financial statement disclosures. SFAS 143 requires that an asset retirement cost should be capitalized as part of the cost of the related long-lived asset and subsequently allocated to expense using a systematic and rational method. The Company will adopt the statement effective no later than January 1, 2003, as required. The transition adjustment resulting from the adoption of SFAS 143 will be reported as a cumulative effect of a change in accounting principle. At this time, the Company cannot reasonably estimate the effect of the adoption of this statement on its financial position, results of operations, or cash flows

In October 2001, the FASB also approved SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 replaces SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." The new accounting model for long-lived assets to be disposed of by sale applies to all long-lived assets, including discontinued operations, and replaces the provisions of APB Opinion No. 30, "Reporting Results of Operations-Reporting the Effects of Disposal of a Segment of a Business," for the disposal of segments of a business. Statement 144 requires that those long-lived assets be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. Therefore, discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. Statement 144 also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The provisions of Statement 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, are to be applied prospectively. At this time, the Company cannot estimate the effect of this statement on its financial position, results of operations, or cash flows.

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-21.

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

None.

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PART III

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

We intend to file a definitive proxy statement for the 2002 Annual Meeting of Shareholders with the Securities and Exchange Commission within 120 days of December 31, 2001. Information regarding our directors will appear under the caption "Election of Directors" in the proxy statement and is incorporated herein by reference. Information regarding compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, and executive officers will appear under the captions "Executive Compensation" -- Section 16(a) Principal Shareholders and Share Ownership of Management and Directors in the proxy statement and is incorporated herein by reference

Item 10. Executive Compensation.

Information regarding executive compensation will appear under the captions "Compensation of Directors," "Executive Compensation" in the proxy statement and is incorporated herein by reference.

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

Information regarding security ownership of certain beneficial owners and management will appear under the caption "Principal Shareholders and Share Ownership of Management and Directors" in the proxy statement and is incorporated herein by reference.

Item 12. Certain Relationships and Related Transactions.

Information regarding Certain Relationships and Related Transactions will appear under the caption "Certain Relationships and Related Transactions" in the proxy statement and is incorporated herein by reference. 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	1996 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)

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10.9	Loan Commitment and Letter Agreement(5)
10.10	Promissory Note(5)
10.11	Employment Agreement with Robert O. Smith (6)
10.12	Securities Purchase Agreement Between the Company and Telkoor Telecom, Ltd. (7)
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.
23.1	Consent of Hein + Associates LLP

(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.
(6) Previously filed with the Commission with its Form 10-KSB for the year ended December 31, 1999.
(7) Previously filed with the Commission with its Form 8-K filed November 21,

2001.

(b) Reports on Form 8-K

On November 21, 2001, we filed a Form 8-K disclosing the consummation of the Securities Purchase Agreement with Telkoor Telecom and resulting change in control

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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: March 25, 2002

DIGITAL POWER CORPORATION,
a California Corporation

/s/ David Amitai

David Amitai,
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/ David Amitai David Amitai, Chief Executive Officer (Principal Executive Officer)	March 25, 2002
/s/ Uri Friedlander Uri Friedlander, Chief Financial Officer (Principal Accounting and Financial Officer)	March 29, 2002
Ben Zion Diamant, Director	March __, 2002
/s/ Josef Berger Josef Berger, Director	March 25, 2002
Mark L. Thum, Director	March __, 2002
/s/ Robert Smith	March 25, 2002

Robert Smith, Director

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying consolidated balance sheet of Digital Power Corporation and subsidiaries as of December 31, 2001, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years ended December 31, 2001 and 2000. These consolidated 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 auditing standards generally accepted in the United States of America. 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, 2001, and the results of their operations and their cash flows for the years ended December 31, 2001 and 2000, in conformity with accounting principles generally accepted in the United States of America.

/s/HEIN + ASSOCIATES LLP

HEIN + ASSOCIATES LLP
Certified Public Accountants

Orange, California
February 19, 2002

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DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

	DECEMBER 31, 2001
ASSETS	
CURRENT ASSETS:	

Cash and cash equivalents	$ 1,242,900
Accounts receivable - trade, net of allowance for doubtful accounts of $370,000	2,203,664
Income tax refund receivable	72,388
Other receivables	91,971
Inventories, net	1,999,168
Prepaid expenses and deposits	47,534
Total current assets	5,657,625
PROPERTY AND EQUIPMENT, net	820,318
OTHER ASSETS	35,116
TOTAL ASSETS	$ 6,513,059

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:	
Notes payable	$ 652,261
Current portion of capital lease obligations	35,856
Accounts payable	1,590,830
Accrued liabilities	1,510,719
Total current liabilities	3,789,666
CAPITAL LEASE OBLIGATIONS, less current portion	24,376
OTHER LONG TERM LIABILITIES	13,607
Total liabilities	3,827,649
COMMITMENTS AND CONTINGENCIES (Notes 8 and 13)	
STOCKHOLDERS' EQUITY:	
Preferred stock issuable in series, no par value, 2,000,000 shares authorized, no shares issued or outstanding	-
Common stock, no par value, 10,000,000 shares authorized, 4,510,680 shares issued and outstanding	11,036,251
Additional paid in capital	733,256
Accumulated deficit	(8,771,654)
Accumulated other comprehensive loss	(312,443)
Total stockholders' equity	2,685,410
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 6,513,059

See accompanying notes to these consolidated financial statements.

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DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31,

	2001	2000
REVENUES	$ 10,329,857	$ 17,882,730
COST OF GOODS SOLD	11,939,985	13,223,441
Gross margin (loss)	(1,610,128)	4,659,289
OPERATING EXPENSES:		
Research and development	1,065,872	1,166,015
Marketing and selling	863,898	1,348,545
General and administrative	2,177,611	1,895,280
Impairment of goodwill	946,263	-
Total operating expenses	5,053,644	4,409,840
INCOME (LOSS) FROM OPERATIONS	(6,663,772)	249,449
OTHER INCOME (EXPENSE):		
Interest income	12,829	29,920
Interest expense	(63,461)	(90,992
Other (expense)	(4,364)	-
Gain (loss) on disposal of assets	(23,069)	10,790
Other (expense)	(78,065)	(50,282
INCOME (LOSS) BEFORE INCOME TAXES	(6,741,837)	199,167
INCOME TAX PROVISION	298,883	104,000
NET INCOME (LOSS)	$ (7,040,720)	$ 95,167
Basic net income (loss) per share	$ (2.07)	$ 0.03
Diluted net income (loss) per share	$ (2.07)	$ 0.03

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DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2001 and 2000

	COMMON STOCK SHARES	COMMON STOCK AMOUNT	ADDITIONAL PAID-IN CAPITAL	NOTE RECEIVABLE - STOCKHOLDER	ACCUMULATED DEFICIT	ACCUM OTHER REHE (L
BALANCES, January 1, 2000	2,771,435	$ 9,012,679	$ 566,504	$ (52,200)	$ (1,826,101)	$ (4
Exercise of stock options	484,245	754,197	(52,200)	52,200	-	
Income tax benefit related to exercise						

of stock options	-	-	101,397	-	-	
Stock granted for services	5,000	19,375	-	-	-	
Compensation cost recognized upon issuance of warrants for services	-	-	117,555	-	-	
Comprehensive loss:						
Net income	-	-	-	-	95,167	
Foreign currency translation adjustment	-	-	-	-	-	(19
Total comprehensive loss	-	-	-	-	-	
BALANCES, December 31, 2000	3,260,680	9,786,251	733,256	-	(1,730,934)	(24
Issuance of common stock to Telkoor Telecom, Ltd. pursuant to investment agreement	1,250,000	1,250,000	-	-	-	
Comprehensive loss:						
Net loss	-	-	-	-	(7,040,720)	
Foreign currency translation adjustment	-	-	-	-	-	(6
Total comprehensive loss	-	-	-	-	-	
BALANCES, December 31, 2001	4,510,680	$ 11,036,251	$ 733,256	$ -	$ (8,771,654)	$ (31

See accompanying notes to these consolidated financial statements

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DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	FOR THE YEARS ENDED DECEMBER 31,	
	2001	2000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (7,040,720)	$ 95,1
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		

Depreciation and amortization	450,752	475,9
(Gain) loss on disposal of assets	23,069	(10,7
Deferred income taxes	334,037	16,7
Warranty expense	(64,806)	55,0
Increase in provision for inventory obsolescence	2,714,941	
Bad debt expense	158,130	23,5
Compensation cost recognized upon issuance of warrants	-	117,5
Income tax benefit related to exercise of stock options	-	101,3
Stock issued for services	-	19,3
Impairment of goodwill	946,263	
Severance accrual	658,000	
Changes in operating assets and liabilities:		
Accounts receivable	894,288	(466,5
Income tax refund receivable	106,812	(108,2
Other receivables	(1,517)	9,4
Inventories	429,515	(612,3
Prepaid expenses	166,164	(152,3
Other assets	(6,565)	(14,4
Accounts payable	(358,353)	753,0
Accrued liabilities	(252,177)	(98,9
Other long-term liabilities	13,607	(25,0
Net cash provided by (used in) operating activities	(828,560)	178,4
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(133,281)	(176,0
Proceeds from sale of assets	5,876	26,1
Net cash (used in) investing activities	(127,405)	(149,9

(Continued)

DIGITAL POWER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)

	FOR THE YEARS ENDED DECEMBER 31,	
	2001	2000
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and warrants	$ -	$ 754,1
Proceeds received (payments made) on notes payable	252,261	(540,0
Principal payments on capital lease obligations	(44,659)	(62,4
Investment from Telkoor Telecom, Ltd.	1,250,000	

Net cash provided by (used in) financing activities	1,457,602	151,7
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(65,144)	(198,6
NET CHANGE IN CASH AND CASH EQUIVALENTS	436,493	(18,3
CASH AND CASH EQUIVALENTS, beginning of period	806,407	824,7
CASH AND CASH EQUIVALENTS, end of period	$ 1,242,900	$ 806,4
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash payments for:		
Interest	$ 67,009	$ 131,6
Income taxes	$ 97,918	$ 180,0
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Acquisition of equipment through capital leases	$ -	$ 42,8

See accompanying notes to these consolidated financial statements.

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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 was being amortized using the straight-line method over its estimated useful life of ten years.

As a result of DPL's sustained losses during the year ended December 31, 2001, management has determined the value of the unamortized goodwill related to the 1998 acquisition of DPL as impaired resulting in a charge of $946,263.

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 is recorded as a component of accumulated other comprehensive income (loss), a component of stockholders' equity.

Earnings Per Share - Basic earnings per share excludes dilution and is computed by dividing income 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.

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.

The Company operates in one segment, manufacture and sale of power supplies. Financial instruments that subject the Company to credit risk consist of cash balances maintained in excess of federal depository insurance limits and accounts receivable, which have no collateral or security. See Note 14 for major customers.

Fair Value of Financial Instruments - The estimated fair values for financial instruments under FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, are determined at discrete points in time based on relevant market information. These estimates involve uncertainties and cannot be determined with precision. The estimated fair value of cash, cash equivalents, accounts receivable and accounts payable approximates their carry value due to their short-term nature. The estimated fair value of long-term debt approximates its carrying value because it carries interest rates which approximates market rates.

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.

Impact of Recently Issued Standards - In June 2001, the Financial Accounting Standards Board ("FASB") issued Statements of Financial Accounting Standards No. 141 "Business Combinations" ("SFAS 141") and No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for under the purchase method. For all business combinations for which the date of acquisition is after June 30, 2001, SFAS 141 also establishes specific criteria for the recognition of intangible assets separately from goodwill and requires unallocated negative goodwill to be written off immediately as an extraordinary gain, rather than deferred and amortized. SFAS 142 changes the accounting for goodwill and other intangible assets after an acquisition. The most significant changes made by SFAS 142 are: 1) goodwill and intangible assets with indefinite lives will no longer be amortized; 2) goodwill and intangible assets with indefinite lives must be tested for impairment at least annually; and 3) the amortization period for intangible assets with finite lives will no longer be limited to forty years. The Company does not believe that the adoption of these statements will have a material effect on its financial position, results of operations, or cash flows.

In June 2001, the FASB also approved for issuance SFAS 143 "Asset Retirement Obligations." SFAS 143 establishes accounting requirements for retirement obligations associated with tangible long-lived assets, including (1) the timing of the liability recognition, (2) initial measurement of the liability, (3) allocation of asset retirement cost to expense, (4) subsequent measurement of the liability and (5) financial statement disclosures. SFAS 143 requires that an asset retirement cost should be capitalized as part of the cost of the related long-lived asset and subsequently allocated to expense using a systematic and rational method. The Company will adopt the statement effective no later than January 1, 2003, as required. The transition adjustment resulting from the adoption of SFAS 143 will be reported as a cumulative effect of a change in accounting principle. At this time, the Company cannot reasonably estimate the effect of the adoption of this statement on its financial position, results of operations, or cash flows.

In October 2001, the FASB also approved SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 replaces SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." The new accounting model for long-lived assets to be disposed of by sale applies to all long-lived assets, including discontinued operations, and replaces the provisions of APB Opinion No. 30, "Reporting Results of Operations-Reporting the Effects of Disposal of a Segment of a Business," for the disposal of segments of a business. Statement 144 requires that those long-lived assets be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. Therefore, discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. Statement 144 also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The provisions of Statement 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, are to be applied prospectively. At this time, the Company cannot estimate the effect of this statement on its financial position, results of operations, or cash flows.

3. BASIS OF PRESENTATION:

The Company incurred a net loss of $7,040,720 and used cash in operations of $828,560 during the year ended December 31, 2001. The Company had net income of $95,167 and cash provided by operations of $178,499 during the year ended December 31, 2000. The Company had working capital of $1,867,959 and $6,461,665, at December 31, 2001 and 2000, respectively, The increase in net loss and substantial decrease of working capital is due in part to certain non-cash expenses, including, an increase in the inventory allowance for obsolescence of $2,715,000, an impairment of goodwill by $946,000, a severance accrual of $658,000 for employees in Poder, increase in the allowance for bad debt of $158,000, and the valuation taken against the deferred tax asset of $350,000.

The Company's management has addressed the decrease in cash and working capital through the execution of the Securities Purchase Agreement in which the Company received $1,250,000 in cash and developed a strategic alliance with Telkoor Telecom, Ltd. (Telkoor). The Company's management team is currently comprised of officers of Telkoor and if needed, Telkoor has committed to lend to the Company, and/or make further investments in the Company, to sustain its operations. See note 10 for additional terms of the Telkoor investment.

In management's opinion, these proceeds combined with revenue from sales and Telkoor's continued commitment to protect its investment will provide sufficient cash flow to pay the Company's obligations as they come due for at least the next year.

4. INVENTORIES:

Raw materials	$ 3,831,093
Work-in-process	985,924
Finished goods	146,861
	4,963,878
Allowance for obsolescence	(2,964,710)
	$ 1,999,168

During the year ended December 31, 2001, the Company increased the allowance for obsolescence and excess inventories by approximately $2,715,000 which was a result of the cancellation of purchase orders by customers, excess inventory levels, lack of sales orders and delays in delivery of products by two customers. The additional provision for obsolete and excess inventory is included in the cost of sales.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. PROPERTY AND EQUIPMENT:

Property and equipment consist of the following as of December 31, 2001:

Machinery and equipment	$ 1,503,030
Office equipment and furniture	875,726
Leasehold improvements	525,846
Transportation equipment	81,089
	2,985,691
Accumulated depreciation and amortization	(2,165,373)
	$ 820,318

Depreciation expense related to property and equipment for the year ended December 31, 2001 and 2000, was $378,571 and $331,987, respectively.

6. ACCRUED LIABILITIES:

Accrued liabilities consist of the following as of December 31, 2001:

Accrued payroll and benefits	$ 167,129
Accrued commissions and royalties	120,567
Accrued warranty and product return expense	201,094
Income taxes payable	190,175
Severance accrual for PD employees	508,000
Other	323,754
	$ 1,510,719

During the year ended December 31, 2001, the Company recorded an estimated severance liability related to its Mexican subsidiary of $658,000. The severance accrual is a result of depressed sales of the Company's products in the United States, which has resulted in excess capacity of the workforce at its Guadalajara, Mexico facility. In addition, the Company is considering moving a portion of its manufacturing to China which would increase the excess capacity at PD. The liability was reduced in September 2001 by $150,000 for the payment of severance as a result of a reduction of PD employees.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. NOTES PAYABLE:

DPC has a $750,000 line of credit pursuant to a promissory note agreement. The line of credit agreement provides for borrowings up to 80% of eligible accounts receivable. Borrowing under this line of credit bears interest based upon an index equal to the lender's prime rate (totaling 6.75% at December 31, 2001), interest only, payable monthly with outstanding principal due on demand. If no demand is made, the outstanding principal and unpaid accrued interest is due April 15, 2002. At December 31, 2001, the outstanding principal balance was $652,261. Under the terms of the agreement, the Company is required to maintain certain ratios and be in compliance with other covenants. At December 31, 2001, the Company was in compliance with all covenants.

DPL has a (United Kingdom pounds)500,000 bank overdraft facility pursuant to a loan agreement. Borrowing under this line of credit bears interest at 2% per annum over the Bank's Base rate (totaling 6.5% at December 31, 2001), interest only, payable monthly with outstanding principal due on demand. If no demand is made, the outstanding principal and accrued interest is due March 31, 2002. In the event of the loan being used, the loan would be collateralized by substantially all of the DPL's assets. At December 31, 2001, no principal or accrued interest was outstanding.

8. CAPITAL LEASE OBLIGATIONS:

The Company leases certain equipment and vehicles under agreements classified as capital leases. The net book value of assets under capital leases is $59,229. Depreciation expense of $39,545 and $52,147 was recognized for the years ended December 31, 2001 and 2000, respectively.

The future minimum lease payments as of December 31, 2001, are as follows:

YEARS ENDING DECEMBER 31,	AMOUNT
2002	$ 45,736
2003	31,183
Total future minimum lease payments	76,919
Less amount representing interest	(16,687)
Present value of net minimum lease payments	60,232
Less current portion	(35,856)
	$ 24,376

9. 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. As of December 31, 2001, there were no shares issued or outstanding.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. COMMON STOCK:

In September 2001, the Company executed a securities purchase agreement with Telkoor Telecom, Ltd. (Telkoor) for cash proceeds of $1,250,000 in exchange for the purchase of 1,250,000 shares of common stock and the issuance of 900,000 warrants to purchase common stock at an exercise price of $1.25 per share and an additional 1,000,000 warrants to purchase common stock at an exercise price of $1.50 per share. The warrants vest immediately and expire during the year ended December 31, 2003. In addition, the Company's Board of Directors will appoint a number of individuals recommended by Telkoor necessary to constitute a majority of the Board and the then current president and CEO, Robert Smith, will resign as president with an individual selected by Telkoor appointed to the position of president and CEO.

11. 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.

In February 1998, the Company adopted the 1998 Stock Option Plan covering 240,000 shares of common stock. 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 quoted 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, 1999, the Company granted options for the purchase of 11,900 shares of the Company's common stock under the 1998 Stock Option Plan to certain employees. The exercise prices of the options range from $1.5625 to $1.8750 per share, which was equal to the quoted market value on the date of grant. The options vest over 5 years at 25% per year starting in the second year.

In April 2000, the Company adopted the 2000 Stock Option Plan covering 500,000 shares of common stock. 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 quoted 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 years ended December 31, 2001 and 2000, the Company issued in each year non-qualified options for the purchase of 100,000 shares of the Company's common stock to Mr. Robert Smith who was the president of the Company until his resignation on November 13, 2001, in accordance with his employment agreement. The exercise prices of $1.63 and $1.56 per share were equal to the quoted market value on the date of grant. Such options vested immediately and expire beginning in 2009.

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

During the year ended December 31, 2001, the Company granted options for the purchase of 200,000 shares of the Company's common stock to David Amitai, CEO and President, and 200,000 shares of the Company's common stock to Ben Zion Diamant, Chairman of the Board. The exercise price of $0.70 per share was equal to the quoted market value on the date of grant. Such options vest over 2 years at 50% per year starting in the second year.

During each of the years ended December 31, 2001, and 2000, the Company granted non-qualified options under the 1998 plan & 2000 plan for the purchase of 30,000 shares of the Company's common stock to outside directors. The exercise prices range from $0.70 to $2.38 per share were equal to the quoted value on the date of grant. The options vest after one year.

During the year ended December 31, 2001, the Company granted options for the purchase of 136,000 shares of the Company's common stock under the 2000 Stock Option Plan to certain employees. The exercise prices range from $0.70 to $1.18 per share were equal to the quoted market value on the date of grant. The options vest over 4 or 5 years at 25% per year starting in the second year.

During the year ended December 31, 2000, the Company granted options for the purchase of 117,500 shares of the Company's common stock under the 1996 Stock Option Plan to certain employees. The exercise price of $2.38 per share was equal to the quoted 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, 2000, the Company granted options for the purchase of 57,500 shares of the Company's common stock under the 1998 Stock Option Plan to certain employees. The exercise price of $2.38 per share was equal to the quoted 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, 2000, the Company granted options for the purchase of 53,000 shares of the Company's common stock under the 2000 Stock Option Plan to certain employees. The exercise price of the options ranges from $2.38 to $3.88 per share were equal to the quoted market value on the date of grant. The options vest over 5 years at 25% per year starting in the second year.

The following table sets forth activity for all options:

	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE PER SHARE
OUTSTANDING, January 1, 2000	1,083,630	$ 2.09
Granted	366,000	2.16
Forfeited	(26,665)	3.31
Exercised	(484,245)	1.56
OUTSTANDING, December 31, 2000	938,720	$ 2.39
Granted	691,000	0.90
Forfeited	(86,625)	2.10

OUTSTANDING, December 31, 2001	1,543,095	$ 1.74
	==========	=======

DIGITAL POWER CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2001, 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. These options have a weighted average contractual life of 6.25 years.

At December 31, 2001 options to purchase 729,296 shares were exercisable with exercise prices ranging from $1.56 to $3.88 per share, a weighted average exercise price of $2.05 and a weighted average remaining contractual life of 7.45 years. The remaining 773,799 unvested options have exercise prices ranging from $.70 to $1.18, a weighted average contractual life of 9.76 years, and are exercisable as follows:

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
2002	122,337	$ 1.77
2003	330,962	1.17
2004	279,000	1.02
2005	31,500	0.81
2006	10,000	0.70
	773,799	$ 1.19

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

YEAR ENDING DECEMBER 31,	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
2003	30,500	$ 1.80
2006	78,250	1.80
2007	105,500	2.31
2008	317,845	2.78
2009	100,000	1.95
2010	245,000	2.39
2011	666,000	0.87
	1,543,095	$ 1.74

Warrants -During March 1997, the Company granted warrants for the purchase of 15,000 shares of the Company's common stock in connection with investor related services provided to the Company. The warrants have an exercise price of $6.75 per share, vested immediately and expire in 2002.

In October 2000, the Company issued warrants to purchase 60,000 shares of common stock at $3.88 per share to an investor relations firm for services provided. Compensation expense of $117,555 was recognized upon issuance of the warrants. The warrants are immediately exercisable and expired in October 2001.

See footnote 9 for additional warrants issued during the year ended December 31, 2001.

The following sets forth the activity for all warrants:

	NUMBER OF SHARES	AVERAGE EXERCISE PRICE PER SHARE
OUTSTANDING, January 1, 2000	195,000	$ 5.38
Granted	60,000	3.88
OUTSTANDING, December 31, 2000	255,000	5.03
Granted	1,900,000	1.43
Expired	(240,000)	4.92
OUTSTANDING, December 31, 2001	1,915,000	$ 1.42

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 2001 and 2000, 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:

	2001	2000
Net loss	$ (7,413,887)	$ (158,079)
Net loss per common share: Basic and diluted	$ (2.18)	$ (0.05)

The fair value of each option or warrant was estimated on the date of grant using the Black-Scholes option pricing model using the following assumptions: average risk-free interest rates ranging from 4.23% to 5.6%, expected life of five years, dividend yield of 0%; and expected volatility ranging from 55.0% to 125.9%. The weighted-average fair value of the options on the grant date for the years ended December 31, 2001 and 2000 was $0.70 and $0.94 per share, respectively.

12. NET INCOME (LOSS) PER COMMON SHARE:

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

	2001	2000
BASIC		
Net income (loss) applicable to common shareholders	$ (7,040,720)	$ 95,167
Weighted average number of common shares	3,407,930	2,939,034
Basic earnings (loss) per share	$ (2.07)	$ 0.03
DILUTED		
Net income (loss) applicable to common shareholders	$ (7,040,720)	$ 95,167
Weighted average number of common shares	3,407,930	2,939,034
Common stock equivalent shares representing shares issuable upon exercise of stock options	Anti-dilutive	336,349
Weighted average number of shares used in calculation of diluted earnings per share	3,407,930	3,275,383
Diluted earnings (loss) per share	$ (2.07)	$ 0.03

The weighted average shares used in the calculation of diluted earnings per share for the year ended December 31, 2001 and 2000, excludes shares of 1,543,095 and 24,346, respectively, which relate to employee stock options outstanding and 1,915,000 and 255,000 which relates to warrants outstanding.

13. 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, as of December 31, 2001, are as follows:

YEARS ENDING DECEMBER 31,	
2002	$ 327,440
2003	287,760
2004	304,312
2006	310,012
2006	132,362
	$ 1,361,886

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 rates in effect at December 31, 2001. Changes in the conversion

rate will have an impact on the Company's required minimum payments and its operating results.

Rent expense was $350,152 and $172,560 for the years ended December 31, 2001 and 2000, respectively.

Termination Of Employment Agreement/Entering Consulting Agreement - The Company entered into a Termination of Employment Agreement/Entering Consulting Agreement on November 13, 2001, with Robert O. Smith. This Consulting Agreement will continue in effect for a period of three (3) years unless terminated or extended upon mutual agreement. Under the terms of the agreement, Mr. Smith agrees to assist the Company in managing its power supply business and related projects. The agreement requires payment of $100,000 per annum, at the end of each calendar year or pro rated by month. At December 31, 2001, the Company has $15,000 accrued under this agreement. Mr. Smith is entitled to receive options to acquire 100,000 shares of Digital Power's common stock on an annual basis beginning on January 1, 2002 pursuant to Digital Power's stock option plan at an exercise price of $3.00 per share. Mr. Smith has the opportunity to sell to Telkoor Telecom, Ltd up to 50% of the common stock held by him, but under no circumstances more than 5% of the issued and outstanding common stock of the Company on a fully diluted basis as of the date of the sale.

14. MAJOR CUSTOMERS:

The Company frequently sells large quantities of inventory to its customers. For the year ended December 31, 2001, one customer accounted for 13% of the Company's net sales. For the year ended December 31, 2000, three customers accounted for 29% of the Company's net sales. Of the Company's consolidated revenues for the year ended December 31, 2001, 63% of revenues were earned from customers in the United States, 30% from customers in the United Kingdom, and 7% for the rest of the world. Consolidated revenues for the year ended December 31, 2000, were earned 70% from customers in the United States, 21% from customers in the United Kingdom, and 9% for the rest of the world.

For the year ended December 31, 2001 and 2000, DPL contributed 37% and 29%, respectively, of the Company's revenues. No one customer of DPL contributed greater than 10% of the Company's consolidated revenues for the years ended December 31, 2001 and 2000.

15. 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 $12,238 and $12,665 for years ended December 31, 2001 and 2000, respectively.

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 $55,334 and $66,908 to the plan for the years ended December 31, 2001 and 2000, 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.

16. INCOME TAXES:

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

	FOR THE YEARS ENDED DECEMBER 31, 2001	2000
Current		
Federal	$ -	$ 60,000
State	800	21,000
Foreign	(36,506)	23,000
	(35,706)	104,000
Deferred		
Federal	299,995	-
State	50,528	-
Foreign	(15,934)	-
	334,589	-
	$ 298,883	$ 104,000

The components of the net deferred tax asset and liability recognized as of December 31, 2001 are as follows:

Current deferred tax assets (liabilities):

Accounts receivable, principally due to allowance for doubtful accounts	$ 148,518
Compensated absences, principally due to accrual for financial reporting purposes	21,422
Accrued commissions	28,326
Acrrued payroll	10,035
Accrued severance	203,911
Inventory reserve	1,190,035
Warranty reserve	64,764
Stock rotation liability	20,070
UNICAP Credit carryforward	28,546
Accrued liabilities	66,065
Other	(272
	1,781,420
Valuation allowance	(1,781,420
Net current deferred tax asset	$ -
Long-term deferred tax assets (liabilities):	
Net operating loss carryforwards	$ 1,935,548
UNICAP Credit carryforward	74,167
Goodwill	505,188
Depreciation	56,618
	2,571,521
Valuation allowance	(2,571,521
Net long-term deferred tax liability	$ -

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,	
	2001	2000
Total expense computed by applying the U.S. statutory rate	(34.0%)	34.0%
Permanent differences	(0.1)	5.1
State income taxes	0.2	10.9
Tax effect resulting from foreign activities	8.0	(101.0)
Change in valuation allowance	(5.3)	105.2
Change in beginning deferred asset	35.6	0.0
Other	0.0	0.3
	4.4%	54.5%

The Company will continue to assess the realizability of the deferred tax assets in future periods. The valuation allowance increased by $4,049,459 during the year ended December 31, 2001. During March 2001, the Company

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fully valued the deferred tax asset recorded at December 31, 2000 of $350,523 due to the uncertainty of the Company's ability to recognize the benefit of the deferred tax asset in the future. The valuation allowance increased by $212,559 during the year ended December 31, 2000.

At December 31, 2001, the Company has net operating loss carryforwards of approximately $3,599,674 which begin to expire in the year 2020. The Company has California net operating loss carryforwards for the year ended December 31, 2001, of $1,854,876, which expire through 2011. As a result of certain non-qualified stock options, which have been exercised, the tax benefit from the utilization of the net operating loss carryforward will be charged to additional-paid in capital when, and if, the losses are utilized. The net operating loss may be subject to Internal Revenue Code Section 382 limitations.

No provision has been made for U.S. Federal and state income taxes or foreign taxes that may result from future remittance of the undistributed earnings of foreign subsidiaries because it is expected that such earnings will be reinvested overseas indefinitely. Determination of the amount of any unrecognized deferred income tax liability on these unremitted earnings is not practicable.

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:

December 31, 2001

	DPC	PD	DPL	Eliminations	Tot
Revenues	$ 6,475,533	$ -	$ 3,854,324	$ -	$ 10,3
Intersegment Revenues	$ -	$ 778,450	$ 599,848	$ (1,378,298)	$
Interest Income	$ 24,350	$ 310	$ 12,519	$ (24,350)	$ 1
Interest Expense	$ 56,874	$ -	$ 30,937	$ (24,350)	$ 6
Depreciation and Amortization	$ 196,555	$ 139,526	114,671	$ -	$ 45
Income Tax	$ 350,523	$ 11,356	$ (62,996)	$ -	$ 29
Net Income(loss)	$ (5,360,730)	$ (1,596,321)	$ (207,140)	$ 123,471	$ (7,04
Expenditures for					

Segment Assets	$ 104,257	$ 5,424	$ 23,600	$ -	$ 13
Segment Assets	$ 6,833,699	$ 409,601	$ 2,562,562	$ (3,292,803)	$ 6,51

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December 31, 2000

	DPC	PD	DPL	Eliminations	To
Revenues	$ 12,721,567	$ 15,302	$ 5,145,861	$ -	$ 17,
Intersegment Revenues	$ -	$ 3,026,933	$ 483,394	$ (3,510,327)	$
Interest Income	$ 63,010	$ 1,742	$ 5,711	$ (40,543)	$
Interest Expense	$ 79,997	$ 2,021	$ 49,517	$ (40,543)	$
Depreciation and Amortization	$ 303,890	$ 54,346	$ 117,751	$ -	$
Income Tax Expense	$ 80,000	$ -	$ 24,000	$ -	$
Net Income	$ (525,919)	$ 179,333	$ 441,753	$ -	$
Expenditures for Segment Assets	$ 133,972	$ 19,517	$ 65,425	$ -	$
Segment Assets	$ 10,674,886	$ 180,624	$ 2,631,015	$ (1,321,475)	$ 12,