DIGITAL POWER CORP
Form 10QSB
November 15, 2006

U.S. Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-QSB

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

for the quarterly period ended September 30, 2006

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

for the transition period from _______ to _______

COMMISSION FILE NUMBER 1-12711

DIGITAL POWER CORPORATION

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

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

41920 Christy Street, Fremont, CA 94538-3158

(Address of principal executive offices)

(510) 657-2635

(Issuer s telephone number)

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

Yes	No
x	o

Number of shares of common stock outstanding as of November 1, 2006, 6,610,708

DIGITAL POWER CORPORATION

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

AS OF SEPTEMBER 30, 2006

IN U.S. DOLLARS

UNAUDITED

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The Board of Directors
Digital Power Corporation

We have reviewed the accompanying consolidated balance sheet of Digital Power Corporation (the Company) and its subsidiaries as of September 30, 2006, and the related consolidated statements of operations for the nine-month and three-month periods ended September 30, 2006 and 2005 and changes in

Re: Review of unaudited interim consolidated financial statements for the nine-month period ended September 30, 2006

shareholders equity for the nine-month period ended September 30, 2006 and cash flows for the nine-month periods ended September 30, 2006 and 2005. These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated interim financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
November 14, 2006

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

DIGITAL POWER CORPORATION

CONSOLIDATED BALANCE SHEET

U.S. dollars in thousands

		September 30, 2006
		Unaudited
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$	1,921
Restricted cash		99
Trade receivables, net of allowance for doubtful accounts of $124 at September 30, 2006		2,128
Prepaid expenses and other current assets		177
Inventories (Note 3)		1,774
Total current assets		6,099
PROPERTY AND EQUIPMENT, NET		168
Total assets	$	6,267

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

DIGITAL POWER CORPORATION

CONSOLIDATED BALANCE SHEET

U.S. dollars in thousands, except share data

		September 30, 2006
		Unaudited
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$	854
Related party trade payables account		1,421
Deferred revenues		134
Other current liabilities		490
Total current liabilities		2,899
SHAREHOLDERS EQUITY:		
Share capital -		
Series A Redeemable, Convertible Preferred shares with no par value - 500,000 shares authorized, 0 shares issued and outstanding at September 30, 2006		
Preferred shares with no par value - 1,500,000 shares authorized, 0 shares issued and outstanding at September 30, 2006		
Common shares with no par value - 30,000,000 shares authorized; 6,610,708 shares issued and outstanding at September30, 2006		
Additional paid-in capital		13,745
Accumulated deficit		(10,465)
Accumulated other comprehensive income		88
Total shareholders equity		3,368
Total liabilities and shareholders equity	$	6,267

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

DIGITAL POWER CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Nine months ended September 30,		Three months ended September 30,	
	2006	2005	2006	2005
	Unaudited			
Revenues	$ 9,445	$ 7,187	$ 3,404	$ 2,969
Cost of revenues	6,894	5,090	2,496	2,120
Gross profit	2,551	2,097	908	849
Operating expenses:				
Engineering and product development	482	374	172	151
Selling and marketing	909	999	292	319
General and administrative	1,017	797	367	268
Total operating expenses	2,408	2,170	831	738
Operating income (loss)	143	(73)	77	111
Financial income (expenses), net	(14)	(87)	(2)	1
Net income (loss)	$ 129	$ (160)	$ 75	$ 112
Basic net earnings (loss) per share	$ 0.020	$ (0.03)	$ 0.011	$ 0.02
Diluted net earnings (loss) per share	$ 0.019	$ (0.03)	$ 0.011	$ 0.02

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

DIGITAL POWER CORPORATION

STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

U.S. dollars in thousands, except share data

	Common shares						
	Number	**Amount**	**Additional paid-in capital**	**Accumulated deficit**	**Accumulated other comprehensive income (loss)**	**Total other comprehensive income**	**Total shareholders equity**
Balance as of January 1, 2006	6,161,859	$	$ 13,275	$ (10,594)	$ (57)		$ 2,624
Exercise of options granted to a director and employees	213,000		162				162
Conversion of convertible note	235,849		250				250
Stock compensation related to options granted to Telkoor s employees			40				40
Stock compensation related to options granted to employees and consultants			18				18
Comprehensive income:							
Net income				129		$ 129	129
Foreign currency translation adjustments					145	145	145
Total other comprehensive income						$ 274	
Balance as of September 30, 2006 (unaudited)	6,610,708	$	$ 13,745	$ (10,465)	$ 88		$ 3,368

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

DIGITAL POWER CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Nine months ended September 30, 2006	2005
	Unaudited	
Cash flows from operating activities:		
Net income (loss)	$ 129	$ (160)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	57	64
Stock compensation related to options granted to employees	18	5
Stock compensation related to options granted to Telkoor s employees and consultants	40	
Increase in trade receivables, net	(176)	(52)
Increase (decrease) in prepaid expenses and other current assets	(26)	25
Increase in inventories	(231)	(795)
Increase in accounts payable and related parties	318	538
Increase in deferred revenues and other current liabilities	3	46
Net cash provided by (used in) operating activities	132	(329)
Cash flows from investing activities:		
Restricted cash	180	(50)
Purchase of property and equipment	(19)	(21)
Net cash provided by (used in) investing activities	161	(71)
Cash flows from financing activities:		
Exercise of options granted to a director and employees	162	
Proceeds from a convertible note		250
Net cash provided by financing activities	162	250
Effect of exchange rate changes on cash and cash equivalents	57	(26)
Increase (decrease) in cash and cash equivalents	512	(176)
Cash and cash equivalents at the beginning of the period	1,409	1,323
Cash and cash equivalents at the end of the period	$ 1,921	$ 1,147
Supplemental disclosure of non-cash financing activities:		
Conversion of a convertible note	$ 250	$

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

DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 1:- GENERAL

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. The significant accounting policies applied in the annual financial statements of the Company as of December 31, 2005, are applied consistently in these financial statements. In addition, the following accounting policy is applied:

The accompanying unaudited consolidated financial statements as of September 30, 2006 and for the nine-month and three-month periods ended September 30, 2006 and 2005 are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management s discussion and analysis of the financial condition and results of operations, contained in the Company Annual Report on Form 10-KSB for the fiscal year ended December 31, 2005. The results of operations for the nine months ended September 30, 2006 are not necessarily indicative of the results for the entire fiscal year ending December 31, 2006.

b. Accounting for stock-based compensation:

On December 31, 2005, the Company has several stock-based employee compensation plans, which are described more fully in Note 5. Prior to December 15, 2005, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation (SFAS 123). Stock-based employee compensation cost in the amount of $5 and $2 was recognized in the statement of operations for the nine months and three months ended September 30, 2005, respectively only for those options with an exercise price lower than the market value of the underlying Common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), Share-Based Payment (SFAS 123(R)), using the modified-prospective-transition method.

Under that transition method, compensation cost recognized in the nine months of 2006 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). On December 31, 2005, the Company accelerated all of its unvested outstanding employees stock options, and therefore, no compensation costs were included for share-based payments granted prior to January 1, 2006 in the nine month of 2006. Results for prior periods have not been restated.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

As a result of adopting SFAS 123(R) on January 1, 2006, the Company s net income for the nine months and three months ended September 30, 2006, is $18 and $6, respectively lower than if it had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for the nine months and three months ended September 30, 2006 would have been the same, due to immateriality.

Total stock-based compensation expense resulting from stock options included in the consolidated statement of operations for the nine months and three months ended September 30, 2006 was $18 and $6, respectively. This amount was allocated to separate line items in the consolidated statement of operations as required by SFAS 123(R).

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

NOTE 3:- INVENTORIES

	September 30, 2006
	Unaudited
Raw materials, parts and supplies	$ 401
Work in progress	325
Finished products	1,048
	$ 1,774

NOTE 4:- CONVERTIBLE NOTE

In January 2005, the Company entered into a convertible note agreement with Telkoor, a major shareholder, according to which Telkoor extended a $250 interest-free convertible note to be paid on the tenth business day after the Company announced its financial results for 2005. The note was convertible at any time into Common shares at a rate of $1.06 per share, which is equal to the quoted market price of the Company s Common stock on the date the note was approved and signed. In accordance with the guidelines of APB No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants , EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Instruments , and EITF Issue No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments , the Company has determined that the note had no beneficial conversion feature since the conversion price was equal to the quoted market price of the Company s Common shares at the date the note was approved and signed.

In April 2006, the convertible note was converted into 235,849 Common shares.

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

NOTE 5:- ACCOUNTING FOR STOCK BASED COMPENSATION

a. Share Option Plans:

1. Under the Company s stock option plans, options may be granted to employees, officers, consultants, service providers and directors of the Company or its subsidiaries.

2. As of September 30, 2006, the Company has authorized, by several Incentive Share Option Plans, the grant of options to officers, management, other key employees and others of up to 2,272,200 of the Company s Common shares. As of September 30, 2006, an aggregate of 718,680 of the Company s options are still available for future grant.

3. The options granted generally become fully exercisable after four years and expire no later than 10 years from the approval date of the option plan under the terms of grant. Any options that are forfeited or cancelled before expiration become available for future grants.

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

	Nine months ended September 30, 2006			
	Amount of options	**Weighted average exercise price**	**Weighted average remaining contractual term (years)**	**Aggregate intrinsic value *)**
		(unaudited)		
Outstanding at beginning of period	1,009,225	$ 1.01		
Granted	135,000	$ 1.39		
Forfeited	(20,000)	$ 1.08		
Exercised	(213,000)	$ 0.76		
Outstanding at end of period	911,225	$ 1.11	6.86	$ 330,860
Exercisable options at end of period	783,225	$ 1.07	6.42	$ 310,560

*) Calculation of aggregate intrinsic value is based on the share price of the Company s Common shares as of September 30, 2006 ($1.35 per share).

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

NOTE 5:- ACCOUNTING FOR STOCK BASED COMPENSATION (Cont.)

Grants for the nine months ended September 30, 2006:

Under the provisions of SFAS 123(R), the fair value of each option is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. Because Black-Scholes option valuation models incorporate ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based exclusively on historical volatility of the entity s stock as allowed by SFAS 123(R). The entity uses historical data to estimate the expected term of options granted, representing the period of time that options granted are expected to be outstanding; option exercise and employee termination within the valuation model. The risk-free rate of period within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	Nine months ended September 30, 2006
	Unaudited
Expected volatility	103% - 117%
Expected dividends	0%
Expected term (in years)	6 - 7
Risk free rate	4.69% - 5.03%

The weighted-average fair value of options granted during the nine months of 2006 was $1.29. The total intrinsic value of options exercised during the nine months of 2006 was $106.

As of September 30, 2006, there was $107 of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted average period of 3- 4 years.

b. Pro-forma information under SFAS 123(R) for periods prior to fiscal 2006:

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company s stock option plans in all periods presented. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes-option-pricing formula and amortized to expense over the options vesting periods, with the following weighted-average assumption for September 30, 2005: expected volatility of 103%, risk-free interest rates of 4%, dividend yield of 0% and a weighted-average expected life of the option of 7 years.

DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5:- ACCOUNTING FOR STOCK BASED COMPENSATION (Cont.)

	Nine months ended September 30, 2005
	Unaudited
Net loss available to Common shares - as reported	$ (160)
Deduct - stock-based employee compensation - intrinsic value	5
Add - stock-based employee compensation - fair value	(99)
Pro forma net loss	$ (254)
Loss per share:	
Basic and diluted net loss, as reported	$ (0.03)
Pro forma basic and diluted net loss	$ (0.04)

c. Employee Stock Ownership Plan:

The Company has an Employee Stock Ownership Plan (ESOP) covering eligible employees. The ESOP provides for the Employee Stock Ownership Trust (ESOT) to distribute shares of the Company s Common shares as retirement benefits to the participants. The Company has not distributed shares since 1998. As of September 30, 2006, the outstanding Common shares held by the ESOT amount to 167,504 shares.

NOTE 6:- TOTAL COMPREHENSIVE INCOME (LOSS)

	Nine months ended September 30,		Three months ended September 30,	
	2006	2005	2006	2005
	Unaudited			
Net income (loss)	$ 129	$ (160)	$ 75	$ 112
Foreign currency translation adjustments	145	(89)	49	(40)
Comprehensive income (loss)	$ 274	$ (249)	$ 124	$ (72)

DIGITAL POWER CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- NET EARNINGS (LOSS) PER SHARE

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

1. Numerator:

	Nine months ended September 30,		Three months ended September 30,	
	2006	2005	2006	2005
	Unaudited			
Net income (loss) available to Common shareholders	$ 129	$ (160)	$ 75	$ 112

2. Denominator:

Denominator for basic net earnings (loss) per share of weighted average number of Common shares	6,322,032	6,161,859	6,845,468	6,161,859
Effect of dilutive securities:				
Employee stock options	384,506	*)	313,109	*)
Convertible note	112,683	*)		*)
Denominator for diluted net earnings (loss) per Common share	6,819,221	6,161,859	7,158,577	6,161,859

*) Anti-dilutive.

NOTE 8:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

The Company has two reportable geographic segments, see Note 1 for a brief description of the Company s business. The data is presented in accordance with Statement of Financial Accounting Standard No. 131, Disclosure About Segments of an Enterprise and Related Information (SFAS No. 131).

The following data presents the revenues, expenditures and other operating data of the Company s geographic operating segments:

	Nine months ended September 30, 2006			
	DPC	DPL	Eliminations	Total
	(unaudited)			
Revenues	$ 4,375	$ 5,070	$	$ 9,445
Intersegment revenues	405		(405)	
Total revenues	$ 4,780	$ 5,070	$ (405)	$ 9,445
Depreciation expense	$ 13	$ 44	$	$ 57
Operating income	$ 125	$ 18	$	$ 143
Financial expenses, net				(14)
Net income (loss)	$ (30)	$ 159	$	$ 129
Expenditures for segment assets as of September 30, 2006	$ 14	$ 5	$	$ 19
Identifiable assets as of September 30, 2006	$ 2,963	$ 3,304	$	$ 6,267

NOTE 8:- SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)

	Nine months ended September 30, 2005			
	DPC	DPL	Eliminations	Total
	(unaudited)			
Revenues	$ 3,373	$ 3,814	$	$ 7,187
Intersegment revenues	629		(629)	
Total revenues	$ 4,002	$ 3,814	$ (629)	$ 7,187
Depreciation expense	$ 16	$ 48	$	$ 64
Operating loss	$ (101)	$ 28	$	$ (73)
Financial expenses, net				(87)
Net loss	$ (92)	$ (68)	$	$ (160)
Expenditures for segment assets as of September 30, 2005	$ 19	$ 2	$	$ 21
Identifiable assets as of September 30, 2005	$ 2,140	$ 3,564	$	$ 5,704

	Three months ended September 30, 2006			
	DPC	DPL	Eliminations	Total
	(unaudited)			
Revenues	$ 1,514	$ 1,890	$	$ 3,404
Intersegment revenues	87		(87)	
Total revenues	$ 1,601	$ 1,890	$ (87)	$ 3,404
Depreciation expenses	$ 4	$ 14	$	$ 18
Operating income	$ 1	$ 76	$	$ 77
Financial expenses, net				$ (2)
Net income	$ 1	$ 74	$	$ 75
Expenditures for segment assets as of September 30, 2006	$ 12	$ 3	$	$ 15
Identifiable assets as of September 30, 2006	$ 2,963	$ 3,304	$	$ 6,267

NOTE 8 - SEGMENTS, MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)

	Three months ended September 30, 2005			
	DPC	DPL	Eliminations	Total
	(unaudited)			
Revenues	$ 1,272	$ 1,697	$	$ 2,969
Intersegment revenues	431		(431)	
Total revenues	$ 1,703	$ 1,697	$ (431)	$ 2,969
Depreciation expenses	$ 5	$ 16	$	$ 21
Operating income (loss)	$ (10)	$ 121	$	$ 111
Financial expenses, net				1
Net income (loss)	$ (6)	$ 118	$	$ 112
Expenditures for segment assets as of September 30, 2005	$ 11	$	$	$ 11
Identifiable assets as of September 30, 2005	$ 2,140	$ 3,564	$	$ 5,704

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

With the exception of historical facts stated herein, the matters discussed in this report are forward looking statements that involve risks and uncertainties that could cause actual results to differ materially from projected results. Such forward looking statements include, but are not necessarily limited to, statements regarding anticipated levels of future revenues and earnings from operations of the Company. Factors that could cause actual results to differ materially include, in addition to other factors identified in this report, dependence on the electronic equipment industry, competition in the power supply industry, dependence on manufacturers in China and other risks factors detailed in the Company s Form 10-KSB for the year ended December 31, 2005. Readers of this report are cautioned not to put undue reliance on forward looking statements which are, by their nature, uncertain as reliable indicators of future performance. The Company disclaims any intent or obligation to publicly update these forward looking statements, whether as a result of new information, future events, or otherwise.

GENERAL

We are engaged in the business of designing, developing, manufacturing, marketing, selling and distributing switching power supplies to the industrial, telecommunication, data communication, medical and military industries. Revenues are generated from sales to distributors and OEMs in North America and Europe.

We have continued our efforts to increase sales to existing and new customers, and continue our strategy to manufacture our products in the Far East. While we believe our revenues have increased to a sufficient amount to offset our expenses, we may be subject to net losses in an individual quarter. We believe that our cash will be sufficient to fund those losses for at least 12 months.

The Company s corporate office, which contains our administrative, sales, and engineering functions, is located in Fremont, California. In addition the Company has a wholly-owned subsidiary, Digital Power Limited (DPL), located in Salisbury, England.

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006, COMPARED TO SEPTEMBER 30, 2005

REVENUES

Total revenues increased by 14.7% to $3,404,000 for the three months ended September 30, 2006, from $2,969,000 for the three months ended September 30, 2005.

Revenues from the domestic operations of DPC increased 19.0% to $1,514,000 for the third quarter ended September 30, 2006, from $1,272,000 for the third quarter ended September 30, 2005. Revenues from the Company s European operations of DPL increased 11.4% to $1,890,000 for the third quarter ended September 30, 2006, from $1,697,000 for the third quarter ended September 30, 2005. The revenue increase in the third quarter of 2006 is mainly due to increase in sales of new products.

For the nine months ended September 30, 2006, revenues increased by 31.4% to $9,445,000 from $7,187,000 for the nine months ended September 30, 2005. Revenues attributed to the domestic operations of DPC increased by 29.7% to $4,375,000 from $3,373,000 for the nine months ended September 30, 2005. Revenues from the Company s European operations of DPL increased by 32.9% to $5,070,000 from $3,814,000 for the nine months ended September 30, 2005. The increase in is mainly due to higher sales of our new products.

GROSS MARGINS

Gross margins were 26.7% for the three months ended September 30, 2006, compared to 28.6% for the three months ended September 30, 2005. Gross margins were 27.0% for the nine months ended September 30, 2006 compared to 29.2 % for the nine months ended September 30, 2005. The decrease in gross margins is mainly a result of the product mix.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 5.1% of revenues for the three months ended September 30, 2006, and for the three months ended September 30, 2005. Engineering and product development expenses were 5.1% of revenues for the nine months ended September 30, 2006, compared to 5.2% of revenues for the nine months ended September 30, 2005. Actual dollar expenditures increased by $108,000 mainly due to safety expenditures.

SELLING AND MARKETING

Selling and marketing expenses were 8.6% of revenues for the three months ended September 30, 2006, compared to 10.7% for the three months ended September 30, 2005. Selling and marketing expenses were 9.6% of revenues for the nine months ended September 30, 2006, compared to 13.9% for the nine months ended September 30, 2005. Actual dollar expenditures decreased by $90,000 mainly due to headcount reduction

GENERAL AND ADMINISTRATIVE

General and administrative expenses were 10.8% of revenues for the three months ended September 30, 2006, compared to 9.0% for the three months ended September 30, 2005. In actual dollar expenditures increased by $99,000 mainly due to a bad debt reserve of $82,000 related to one customer that filed for bankruptcy protection. General and administrative expenses were 10.8% of revenues for the nine months ended September 30, 2006, compared to 11.1% for the nine months ended September 30, 2005. Actual dollar expenditures increased by $220,000 mainly due to bad debt reserve, legal expenses and contract services.

FINANCIAL EXPENSES

Financial expense net was $2,000 for the three months ended September 30, 2006, compared to financial income net of $1,000 for the three months ended September 30, 2005. Financial expenses were $14,000 for the nine months ended September 30, 2006, compared to financial expenses of $87,000 for the nine months ended September 30, 2005. Financial expense and income resulted mainly from the exchange rate fluctuation.

NET INCOME (LOSS)

For the three months ended September 30, 2006, the Company had net income of $75,000 compared to a net income of $112,000 for the three months ended September 2005. Net income for the nine months ended September 30, 2006 was $129,000 compared to net loss of $160,000 for the nine months ended September 30, 2005. Net income is mainly from the increase in revenues.

EQUITY-BASED COMPENSATION EXPENSE

January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all equity-based payment awards made to our employees and directors including employee stock options on estimated fair value. Equity-based compensation expense recognized under SFAS 123(R) for the nine months ended September 30, 2006 was $18,000. Prior to January 1, 2006, the Company accounted for employees equity based compensation plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation (SFAS 123).

The use of Black-Scholes model requires various judgmental assumptions, including estimating stock price volatility, forfeiture rates and exercise behavior.

Expected volatility is based exclusively on historical volatility of the entity s stock as allowed by SFAS 123(R).

If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. See Note 5 to the Consolidated Financial Statements for additional information.

LIQUIDITY AND CAPITAL RESOURCES

On September 30, 2006, the Company had cash, cash equivalents $1,921,000 and working capital of $3,200,000. This compares with cash and cash equivalents of $1,147,000 and working capital of $2,252,000 at September 30, 2005. The increase in working capital is mainly due to increase in cash and cash equivalent and trade receivable, offset partially by decrease in inventory and in deferred revenue.

Cash provided by operating activities for the Company totaled $132,000 for the nine months ended September 30, 2006, compared to cash used in operating activities of $329,000 for the nine months ended September 30, 2005. Cash provided by investing activities was $161,000 for the nine months ended September 30, 2006, compared to cash used in investing activities of $71,000 for the nine months ended September 30, 2005. The cash provided by investing activities was mainly due to release of restricted cash of $180,000. Cash provided by financing activities of $162,000 for the nine month ended September 30, 2006 compared to cash provided of $250,000 for the nine months ended September 30, 2005.

The Company believes it has adequate resources at this time to continue its promotional efforts to increase sales in the electronic industry market. However, if the Company does not meet those goals, it may have to raise money through debts or equity, which may dilute shareholder s equity.

AMEX LISTING

On June 13, 2006, the Company received a written notice from the American Stock Exchange (the AMEX) notifying the Company it has evidenced compliance with the requirements necessary for continued listing on the AMEX.

Previously, on May 3, 2005, the Company had announced that it was subject to delisting because of its shareholders equity of less than $4,000,000, losses from continuing operations, and/or net losses in three out of its four most recent fiscal years. In order to maintain its AMEX listing, the Company submitted a recovery plan on June 3, 2005, advising the AMEX of actions it had taken or would take to bring the Company into compliance with the continued listing standards within a maximum of 18 months. On June 28, 2005, the AMEX approved the Company s recovery plan and allowed uninterrupted trading of the Company s common stock

ITEM 3. CONTROLS AND PROCEDURES

The Company s management with the participation of the Company s principal executive and financial officers evaluated the effectiveness of the Company s disclosure controls and procedures (as defined Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this report. The Company s disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Based upon their evaluation, the Company s principal executive and financial officers concluded that the Company s disclosure controls and procedures are effective to accumulate and communicate to the Company s management as appropriate to allow timely decisions regarding disclosure.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company has submitted a claim for an unpaid debt of $82,799.63 for products sold to Zultys Technologies. Zultys Technologies filed for bankruptcy protection following its failure to pay for the goods the Company had delivered. The Company is represented by counsel in the bankruptcy proceedings. Except for these proceedings, the Company is not currently involved in any legal proceeding

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits	
31.1	Certification of the CEO under the Sarbanes-Oxley Act
31.2	Certification of the CFO under the Sarbanes-Oxley Act
32	Certification of the CEO & CFO under the Sarbanes-Oxley Act

SIGNATURES

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

DIGITAL POWER CORPORATION
(Registrant)

Date: November 15, 2006

/s/ Jonathan Wax

Jonathan Wax,
Chief Executive Officer
(Principal Executive Officer)

Date: November 15, 2006

/s/ Leo Yen

Leo Yen,
Chief Financial Officer
(Principal Financial Officer)