DIGITAL POWER CORP
Form 10-Q
August 13, 2014

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2014

Transition report pursuant to 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 registrant as specified in its charter*)

California	**94-1721931**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*

48430 Lakeview Blvd.

Fremont, CA 94538-3158

(Address of principal executive offices)

(510) 657-2635

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12(b)-2 of the Exchange Act). Yes No

At August 11, 2014, the registrant had outstanding 6,744,769 shares of common stock.

DIGITAL POWER CORPORATION

TABLE OF CONTENTS

2

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share data

	June 30, 2014 Unaudited	**December 31, 2013**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 2,048	$ 1,696
Trade receivables (net of allowance for doubtful accounts of $64 as of June 30, 2014 and $146 as of December 31, 2013)	1,626	2,157
Prepaid expenses and other receivables	228	167
Inventories (Note 3)	1,441	1,751
Total current assets	5,343	5,771
PROPERTY AND EQUIPMENT, NET	589	616
INTANGIBLE ASSET, NET	122	171
INVESTMENT IN TELKOOR	412	406
LONG-TERM DEPOSITS	13	13
Total assets	$ 6,479	$ 6,977
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 912	$ 1,109
Related parties - trade payables	24	248
Advances from customers and deferred revenues	--	128
Other current liabilities	432	445
Total current liabilities	1,368	1,930
SHAREHOLDERS' EQUITY:		
Share capital -		
Series A Redeemable, Convertible Preferred shares, no par value - 500,000 shares authorized and 0 shares outstanding at June 30, 2014 and December 31, 2013	-	-
Preferred shares, no par value - 1,500,000 shares authorized; 0 shares outstanding at June 30, 2014 and December 31, 2013	-	-

Common shares, no par value - 30,000,000 shares authorized; 6,798,510 and 6,853,161 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively.	-	-
Additional paid-in capital	14,594	14,582
Accumulated deficit	(9,291)	(9,282)
Accumulated other comprehensive loss	(192)	(253)
Total shareholders' equity	5,111	5,047
Total liabilities and shareholders' equity	$ 6,479	$ 6,977

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

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Six months ended		**Three months ended**	
	June 30,		**June 30,**	
	2014	**2013**	**2014**	**2013**
	Unaudited			
Revenues	$4,679	$4,416	$2,642	$2,227
Cost of revenues	2,834	2,702	1,559	1,341
Gross profit	1,845	1,714	1,083	886
Operating expenses:				
Engineering and product development	394	349	211	177
Selling and marketing	642	524	330	257
General and administrative	813	751	391	376
Total operating expenses	1,849	1,624	932	810
Operating income (loss)	(4)	90	151	76
Financial income (expense), net	(5)	88	(2)	(5)
Impairment of investment	-	(196)	-	(196)
(Loss) income before income taxes	(9)	(18)	149	(125)
Income taxes	-	-	-	-
Net (loss) income	$(9)	$(18)	$149	$(125)
Basic net (loss) income per share	$(0.001)	$(0.003)	$0.022	$(0.018)
Diluted net (loss) income per share	$(0.001)	$(0.003)	$0.022	$(0.018)

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

4

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

U.S. dollars in thousands

	Six months ended		Three months ended	
	June 30,		June 30,	
	2014	2013	2014	2013
	Unaudited			
Net (loss) income	$(9)	$(18)	$149	$(125)
Other Comprehensive income, net of tax:				
Change in net foreign currency translation adjustment	61	(171)	44	4
Other comprehensive (loss) income	61	(171)	44	4
Total comprehensive (loss) income:	$52	$(189)	$193	$(121)

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

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Common shares Number	Additional paid-in capital	Accumulated deficit	Other accumulated comprehensive loss	Total comprehensive Income	Total shareholders' Equity
Balance as of January 1, 2014	6,853,161	$ 14,582	$ (9,282)	$ (253)	-	$ 5,047
Stock based compensation related to options granted to Telkoor's employees and other non- employee consultants	-	(4)	-	-	-	(4)
Stock based compensation related to options granted to employees	-	86	-	-	-	86
Exercise of employee options	39,749					
Purchase of treasury stock	(94,400)	(70)				(70)
Comprehensive income:						
Net loss	-	-	(9)	-	(9)	(9)
Foreign currency translation adjustments	-	-	-	61	61	61
Total comprehensive income					$ 52	
Balance as of June 30, 2014 (unaudited)	6,798,510	$ 14,594	$ (9,291)	$ (192)		$ 5,111
Balance as of January 1, 2013	6,853,161	14,476	$ (8,650)	$ (299)	-	$ 5,527
Stock based compensation related to options granted to Telkoor's employees and other non- employee consultants	-	(20)	-	-	-	(20)
Stock based compensation related to options granted to employees	-	55	-	-	-	55
Comprehensive income:						
Net loss	-	-	(18)	-	(18)	(18)
Foreign currency translation adjustments	-	-	-	(171)	(171)	(171)
Total comprehensive income					$ (189)	

Balance as of June 30, 2013 (unaudited)	6,853,161	14,511	$ (8,668)	$ (470)	$ 5,373

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

6

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Six months ended June 30, 2014 Unaudited	2013
Cash flows from operating activities :		
Loss	$(9)	$(18)
Adjustments required to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	69	50
Amortization of intangible asset	52	48
Stock based compensation related to options granted to employees	86	55
Stock based compensation related to options granted to Telkoor's employees	(4)	(20)
Impairment of investment in Telkoor	--	196
Decrease (increase) in trade receivables, net	540	(682)
(Increase) in prepaid expenses and other accounts receivable	(61)	(81)
Decrease in inventories	328	161
Decrease in accounts payable and related parties- trade payables	(422)	(48)
Decrease in deferred revenues and other current liabilities	(146)	(15)
Net cash provided (used by) operating activities	433	(354)
Cash flows from investing activities :		
Purchase of property and equipment	(54)	(105)
Proceeds from sales of property and equipment	16	--
Net cash used in investing activities	(38)	(105)
Cash flows from financing activities :		
Purchase of treasury stock	(70)	--
Net cash used in financing activities	(70)	--
Effect of exchange rate changes on cash and cash equivalents	27	(18)
Increase/ (decrease) in cash and cash equivalents	352	(477)
Cash and cash equivalents at the beginning of the period	1,696	1,821

Cash and cash equivalents at the end of the period	$2,048	$1,344

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

7

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

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

b. The Company depends on Telkoor Telecom Ltd. ("Telkoor"), a major shareholder of the Company and one of DPC's third party subcontractors, for manufacturing capabilities in production of the products which DPC sells. If these manufacturers are unable or unwilling to continue manufacturing the Company's products in required volumes on a timely basis, that could lead to loss of sales, and adversely affect the Company's operating results and cash position. The Company also depends on Telkoor's intellectual property and ability to transfer production to third party manufacturers. Failure to obtain new products in a timely manner or delay in delivery of product to customers will have an adverse effect on the Company's ability to meet its customers' expectations. In 2010, the Company purchased a specific intellectual property (IP) fromTelkoor in order to reduce its dependency on Telkoor with respect to a certain line of products.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited consolidated financial statements as of June 30, 2014 and for the six months ended June 30, 2014 and 2013 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’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results for the entire fiscal year ending December 31, 2014.

The significant accounting policies applied in the annual financial statements of the Company as of December 31, 2013 are applied consistently in these financial statements. In addition, the following accounting policy is applied:

8

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:- INVENTORIES

	June 30, 2014 Unaudited	**December 31, 2013**
Raw materials, parts and supplies	$ 218	$ 186
Work in progress	283	428
Finished products	940	1,137
	$ 1,441	$ 1,751

NOTE 4:- ACCOUNTING FOR STOCK-BASED COMPENSATION

a. Stock 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 subsidiary.

2. As of June 30, 2014, the Company has authorized according to the Incentive Share Option Plans, the grant of options to officers, management, other key employees and others of up to 1,373,000, 513,000, 240,000 and 1,519,000, respectively, for the Company’s Common shares. For all four Incentive Option Plans, the maximum term of the options is ten years from date of grant. As of June 30, 2014, an aggregate of 787,630 shares of the Company’s common stock 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 date of the option 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:

	Six months ended June 30, 2014			
	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value (*)
Outstanding at the beginning of the period	712,763	$ 1.33	5.38	$ -
Outstanding at the end of the period	1,287,763	$ 1.57	8.16	$ 30
Exercisable options at the end of the period	397,263	$ 1.44	5.55	$ 19

(*) Calculation of aggregate intrinsic value is based on the share price of the Company's common stock as of June 30, 2014 ($ 1.16 per share).

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- ACCOUNTING FOR STOCK-BASED COMPENSATION (Cont.)

a. Stock option plans (cont.):

4. Under the provisions of ASC 718, the fair value of each option is estimated on the date of grant using a Black-Sholes option valuation model that uses the assumptions such as stock price on the date of the grant, exercise price, risk-free interest rate, expected volatility, expected life and expected dividend yield of the option. Expected volatility is based exclusively on historical volatility of the entity's stock as allowed by ASC 718. The Company uses historical information with respect to the employee options exercised to estimate the expected term of options granted, representing the period of time that options granted are expected to be outstanding. The risk-free interest 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.

Options for 750,000 shares of the Company’s common shares were granted during the first six months of 2014 (April 2, 2014). No options were granted during the first six months of 2013.

The total employee's equity-based compensation expense related to all of the Company's equity-based awards, recognized for the six months and three months ended June 30, 2014 and 2013 is comprised as follows:

	Six months ended		**Three months ended**	
	June 30, 2014	**June 30, 2013**	**June 30, 2014**	**June 30, 2013**
	Unaudited	**Unaudited**	**Unaudited**	**Unaudited**
Sales and marketing expenses	5	2	4	2
Research and development	7	--	6	--
General and administrative	74	53	54	26

Total employees equity-based compensation expense	86	55	64	28

As of June 30, 2014, there was $ 932 of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the stock option plans. That cost is expected to be recognized over a period of the next 3.5 years.

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- ACCOUNTING FOR STOCK-BASED COMPENSATION (Cont.)

Employee Stock Ownership Plan:

b. The Company had an Employee Stock Ownership Plan (ESOP) until July 31, 2014 at which time it was entirely liquidated after a decision to terminate the plan as of July 31, 2013 was previously made. The ESOP provided for the Employee Stock Ownership Trust ("ESOT") to distribute shares or cash equivalents of the Company's Common shares as retirement benefits to the participants. As of July 30, 2014, the ESOT had distributed all of the 167,504 shares of common stock previously held prior to plan termination.

NOTE 5:- NET INCOME PER SHARE

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

1. Numerator:

	Six months ended June 30, 2014	2013	Three months ended June 30, 2014	2013
	Unaudited			
Net (loss) income available to Common shareholders	$(9)	$(18)	$149	$(125)

2. Denominator:

	Six months ended	Three months ended

	June 30, 2014 Unaudited	2013	June 30, 2014	2013
Denominator for basic net income per share of weighted average number of common shares	6,828,263	6,853,161	6,815,793	6,853,161
Effect of dilutive securities:				
Employee stock options	26,098	-	20,396	-
Denominator for diluted net income per common share	6,854,361	6,853,161	6,836,189	6,853,161

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- SEGMENTS

The Company has two reportable geographic segments (see Note 1 for a brief description of the Company's business).

The following data presents the revenues, expenditures and other operating data of the Company's geographic operating segments in accordance with ASC 218 (formerly SFAS No. 131) "Segment Reporting".

	Six months ended June 30, 2014 (unaudited)			
	DPC	**DPL**	**Eliminations**	**Total**
Revenues	$2,642	$2,037	$ -	$4,679
Intersegment revenues	119	-	(119)	-
Total revenues	$2,761	$2,037	$ (119)	$4,679
Depreciation and amortization	$36	$85	$ -	$121
Operating income (loss)	$(132)	$128	$ -	$(4)
Tax expense				**$-**
Net income (loss)	$(132)	$123	$ -	$(9)
Expenditures for segment assets, net of retirements	$52	$(14)	$ -	$38
Total assets as of June 30, 2014	$3,330	$3,149	$ -	$6,479

	Six months ended June 30, 2013 (unaudited)			
	DPC	**DPL**	**Eliminations**	**Total**
Revenues	$2,508	$1,908	$ -	$4,416
Intersegment revenues	199	-	(199)	-
Total revenues	$2,707	$1,908	$ (199)	$4,416
Depreciation and amortization	$19	$80	$ -	$99
Operating income	$57	$33	$ -	$90

Tax expense				$ -
Net income	$ 56	$ (74)	$ -	$ (18)
Expenditures for segment assets	$ 86	$ 19	$ -	$ 105
Total assets as of June 30, 2013	$ 3,890	$ 2,796	$ -	$ 6,671

DIGITAL POWER CORPORATION AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- SEGMENTS (Cont.)

	Three months ended June 30, 2014 (unaudited)			
	DPC	**DPL**	**Eliminations**	**Total**
Revenues	$1,476	$1,166	$ -	$2,642
Intersegment revenues	112	0	(112)	-
Total revenues	$1,588	$1,166	$ (112)	$2,642
Depreciation expense	$20	$40	$ -	$60
Operating income (loss)	$16	$135	$ -	$151
Tax expense				$-
Net income (loss)	$16	$133	$ -	$149
Expenditures for segment assets, net of retirements	$14	$2	$ -	$16
Total assets as of June 30, 2014	$3,330	$3,149	$ -	$6,479

	Three months ended June 30, 2013 (unaudited)			
	DPC	**DPL**	**Eliminations**	**Total**
Revenues	$1,376	$851	$ -	$2,227
Intersegment revenues	161	0	(161)	-
Total revenues	$1,535	$851	$ (161)	$2,227
Depreciation expense	$11	$40	$ -	$51
Operating income	$57	$19	$ -	$76
Tax expense				$-
Net income	$56	$(181)	$ -	$(125)
Expenditures for segment assets	$53	$2	$ -	$55
Total assets as of June 30, 2013	$3,890	$2,796	$ -	$6,671

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on our expectations, beliefs, forecasts, intentions and future strategies and are signified by the words "expects," "anticipates," "intends," "believes" or similar language. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business and other characterizations of future events or circumstances are forward-looking statements. These forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under "Part II, Item 1A. Risk Factors" and elsewhere in this report. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. All forward-looking statements included in this quarterly report are based on information available to us on the date of this report and speak only as of the date hereof. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

In this quarterly report, the "Company," "Digital Power," "we," "us" and "our" refer to Digital Power Corporation, a California corporation, and our wholly-owned subsidiary, Digital Power Limited.

GENERAL

Digital Power Corporation is a solution-driven organization that designs, develops, manufactures and sells high-grade customized and flexible power system solutions for the most demanding applications in the medical, military, telecom and industrial markets. We are highly focused on high-grade and custom product designs for the commercial, medical and military/defense markets, where customers demand high density, high efficiency and ruggedized products to meet the harshest and/or military mission critical operating conditions. We are a California corporation originally formed in 1969, and our common stock trades on the NYSE MKT under the symbol "DPW". Our corporate headquarters are located in the heart of the Silicon Valley.

We also have a wholly-owned subsidiary, Digital Power Limited ("DPL"), which operates under the brand name of "Gresham Power Electronics" ("Gresham"). DPL is located in Salisbury, England, and it designs, manufactures and sells power products and system solutions mainly for the European marketplace, including power conversion, power distribution equipment, DC/AC (Direct Current/Active Current) inverters and UPS (Uninterrupted Power Supply) products. DPL's defense business has specialists in the field of naval applications of power distribution conversion.

We believe that we are one of the first companies in the power solutions industry to introduce a product strategy based on the premise that products developed with an extremely flexible architecture enable rapid modifications to meet unique customer requirements for non-standard output voltages. The development and implementation of this strategy has resulted in broad acceptance in the telecom/industrial, and increasingly in the medical market, segments for our new line of high density and high efficiency power products. These products set an industry standard for providing high-power output in package sizes that are among the smallest available for such commercial products.

We market and sell our products to many diverse market segments, including the telecom, industrial, medical and military/defense industries. Our products serve a global market, with an emphasis on North America and Europe. We offer a broad product variety, including a full custom product design, standard and modified standard products. Our unique high speed switching power rectifiers includes, but is not limited to custom power products, front end, open frame, enclosed, Compact PCI, MicroTCA, PoE (Power over Ethernet) and other product solutions providing power output from 50 to 24,000 watts.

In an effort to provide short lead-times, high quality products and competitive pricing to support our markets, we have entered into production agreements with several contract manufacturers located in Asia, primarily China. These agreements allow us to better control production costs and ensure high quality products deliverable in a timely manner to meet market demand.

We intend to remain an innovative leader in the development of cutting-edge custom power solutions and feature rich products to meet any customer needs and requirements, rugged power systems to meet harsh and extreme operation environmental requirements, and high performance, high efficiency, high-density and modular power systems. We are focusing today on developing even more high-grade custom power system solutions for numerous customers in a broadly diversified range of markets and challenging environments. Each product development is based on best of class performance criteria, including unique, advanced feature sets and a special layout to meet our customers' unique operating conditions where efficiency, size and time to market are key to their success. We are taking initiatives to develop and sell high efficiency "green power" solutions.

RESULTS OF OPERATIONS

THREE AND SIX MONTHS ENDED JUNE 30, 2014 COMPARED TO JUNE 30, 2013

Revenues

Our revenues increased by 18% to $2.6 million for the three months ended June 30, 2014, from $2.2 million for the three months ended June 30, 2013. The increase in revenues was mainly due to an increase in shipments of military products of our European operation. Gross revenues of our U.S. operations increased slightly from higher customized product shipments.

For the six months ended June 30, 2014, our revenues increased by 6% to $4.7 million from $4.4 million for the six months ended June 30, 2013. The increase in revenues was attributable primarily to the increase in shipments of military products of our European operation.

Our revenues are highly dependent on the timing of customer delivery requirements. We experienced an increase in defense related shipments in the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013 and expect that trend to continue through the end of fiscal 2014. However, based upon our current backlog of commercial orders and the timing of deliveries of such orders, we expect a decline in commercial shipments and revenues, at least for the quarter ended September 30, 2014, as compared to the year ago quarter ended September 30, 2013 and the prior quarter ended June 30, 2014.

Gross Margins

Gross margins increased slightly to 41.0% for the three months ended June 30, 2014, compared to 39.8% for the three months ended June 30, 2013. Gross margins for the six months ended June 30, 2014 increased to 39.4% compared to the gross margins of 38.8% for the six months ended June 30, 2013. The increase in gross margins for the three and six months ended June 30, 2014 was mainly due primarily to effect of higher revenues on fixed manufacturing overhead costs and to a lesser extent on the higher mix of defense related shipments As previously mentioned with respect to revenues, although we expect our margins on defense related shipments to continue their upward trend through the end of fiscal 2014, we expect a decline in margins of our commercial products due to the timing of shipments of our current order backlog, at least through the quarter ended September 30, 2014.

Engineering and Product Development

Engineering and product development expenses were $211,000 or 8.0% of revenues for the three months ended June 30, 2014, compared to $177,000 or 7.9% of revenues for the three months ended June 30, 2013. Engineering and product development expenses were $394,000 or 8.4% of revenues for the six months ended June 30, 2014 as compared to $349,000 or 7.9% of revenues for the six months ended June 30, 2013. The overall slight increase in our engineering and product development expenses for the comparative six month periods was mainly due to the timing of safety license fee expenses during the first quarter of fiscal 2014.

Selling and Marketing

Selling and marketing expenses were $330,000 or 12.5% of revenues for the three months ended June 30, 2014 as compared to $257,000 or 11.5% of revenues for the three months ended June 30, 2013. Selling and marketing expenses were $642,000 or 13.7% of revenues for the six months ended June 30, 2014 as compared to $524,000 or 11.9% of revenues for the six months ended June 30, 2013. The increase in selling and marketing expenses for the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013 was primarily related to the addition of regional sales management personnel in the domestic operations.

General and Administrative

General and administrative expenses were $391,000 or 14.8% of revenues for the three months ended June 30, 2014 as compared $376,000 or 16.9% of revenues for the three months ended June 30, 2013. General and administrative expenses were $813,000 or 17.4% of revenues for the six months ended June 30, 2014 as compared to $751,000 or 17.0% of revenues for the six months ended June 30, 2013. The slight increase in the gross spending amount in the three months ended June 30, 2014 compared to the three months ended June 30, 2013 was attributable to higher stock option expenses related to incremental grants made on April 2, 2014 offset by lower consulting expenses. The higher increase in the six months ended June 30, 2014 compared to the six months ended June 30, 2013 was mainly attributable to higher travel, legal, and investor relations expenses incurred in the three months ended March 31, 2014 period compared to the three months ended March 31, 2013 period.

Financial Income (Expense)

Financial expense was $2,000 for the three months ended June 30, 2014 compared to $5,000 for the three months ended June 30, 2013. The decrease in expense for these comparable periods was solely attributable to foreign currency fluctutation differences. Financial expense was $5,000 for the six months ended June 30, 2014 compared to financial income of $88,000 for the six months ended June 30, 2013. The change in financial results for the comparable six month periods was mainly due to a dividend of $63,000 received from Telkoor in the quarter ended March 31, 2013 which was not received in the comparable 2014 reporting period.

Impairment of Investment

For the quarter and six months ended June 30, 2013, the Company recorded an impairment of $196,000 on the investment made in Telkoor equity shares based on independent valuation obtained. There were no impairment charges in the comparable period ended on June 30, 2014**.**

LIQUIDITY AND CAPITAL RESOURCES

On June 30, 2014, we had cash and cash equivalents of $2.0 million and working capital of $4.0 million. This compared with cash and cash equivalents of $1.7 million and working capital of $3.8 million at December 31, 2013. The increase in cash and cash equivalents and working capital was due mainly to a significant decrease in trade receivables and inventories partially offset by a decrease in accounts payable and deferred revenues and other current liabilites.

Net cash provided by operating activities totaled $433,000 for six months ended June 30, 2014 compared to net cash used by operating activities of $354,000 for the six months ended June 30, 2013. The increase in cash provided by operating activities for the comparable periods was primarily the result of the reduction of accounts receivable balances.

Net cash used in investing activities was $38,000 for the six months ended June 30, 2014 compared to $105,000 for the six months ended June 30, 2013. The net usage of cash for investing activities in 2014 and 2013 was due to a purchase of equipment.

Net cash used by financing activities was $70,000 for the six month period ending June 30, 2014 and represented purchases of treasury stock related to the liquidation of the Company's Employee Stock Ownership Plan. There were no financing activities in the six months ended June 30, 2013.

We believe we have adequate resources at this time to continue our operational and promotional efforts to increase sales and support our current operation. However, if we do not increase our sales, we may have to raise money through debt or equity, which may dilute shareholders' equity.

CRITICAL ACCOUNTING POLICIES

In our Annual Report on Form 10-K for the year ended December 31, 2013, we identified the critical accounting policies which affect our more significant estimates and assumptions used in preparing our consolidated financial statements. The basis for developing the estimates and assumptions within our critical accounting policies is based on historical information and known current trends and factors. The estimates and assumptions are evaluated on an ongoing basis and actual results have been within our expectations. We have not changed these policies from those previously disclosed in our Annual Report.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable for a smaller reporting company.

ITEM 4T. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We have established disclosure controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to management, including the principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure.

Our principal executive officer and principal financial officer, with the assistance of other members of the Company's management, have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this quarterly report. Based upon such evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures are effective as of the end of the period covered by this quarterly report.

Changes in Internal Control over Financial Reporting

During the period covered by this quarterly report, there were no changes in our internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

The risk factors listed in this section provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. Readers should be aware that the occurrence of any of the events described in these risk factors could have a material adverse effect on our business, results of operations and financial condition. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

Although we generated an operating income during the three months ended June 30, 2014, we have historically experienced operating and net losses and we may experience such losses in the future.

For the six months ended June 30, 2014, we had operating loss of $4,000 and a net loss of $9,000 compared to an operating income of $90,000 and a net loss of $18,000 for the six months ended June 30, 2013. For the year ended December 31, 2013, we had an operating loss of $317,000 and a net loss of $632,000. Although we have actively taken steps to increase our revenue and reduce manufacturing and operating costs, we may incur operating and net losses in the future unless we continue to increase revenues by selling current and custom design products, and continue seeking manufacturing cost reductions through offshore strategic agreements with contract manufacturers. Consolidated revenues were the highest in the quarter ended June 30, 2014 since the quarter ended June 30, 2012 but there is no assurance that we will sustain those levels – in fact we expect revenues for the quarter ended September 30, 2014 to be lower than the quarter ended June 30, 2014 and possibly lower the comparable year ago quarter ended September 20, 2013.

We depend on Telkoor to design and manufacture some of our products.

We depend on Telkoor, our largest shareholder and one of our third party subcontractors, for design and manufacturing capabilities for some of the products that we sell. If Telkoor is unable or unwilling to continue designing or manufacturing our products in required volumes and with a certain level of quality on a timely basis, that could lead to loss of sales and adversely affect our operating results and cash position. We also depend on Telkoor's intellectual property and ability to transfer production to third party manufacturers. Failure to obtain new products in a timely manner or delay in delivery of products to customers will have an adverse effect on our ability to meet our customers' expectations. In addition, we operate in highly competitive markets where our ability to sell Telkoor's products could be adversely affected by Telkoor's agreements with other companies, long lead-times and the high cost of Telkoor's products.

Also, in 2012, Telkoor's manufacturing lead-times increased, which has hindered our ability to respond to our customers' needs. Telkoor's principal offices, research and development and manufacturing facilities are located in Israel. Political, economic, and military conditions in Israel directly affect Telkoor's operations. We are also dependent upon Telkoor's terms and conditions with its contract manufacturers for some of our products, which terms and conditions may not always be in our best interest. In 2010, the Company purchased a certain IP from Telkoor in order to reduce its dependency on Telkoor with respect to a certain line of products.

We also entered into a Manufacturing Rights Agreement with Telkoor in 2012 pursuant to which we were granted the non-exclusive right to directly place purchase orders for certain products from third party manufacturers in consideration for payment of royalties.

We are dependent upon our ability, and our contract manufacturers' ability, to timely procure electronic components.

Because of the global economy, many raw material vendors have reduced capacities, closed production lines and, in some cases, even discontinued their operations. As a result, there is a global shortage of certain electronic components, which has extended our production lead-time and our production costs. For example, in some cases, finished goods that used to be available in 12 weeks for a production purchase order are now available only after 22 weeks. Also, some materials are no longer available to support some of our products, thereby requiring us to search for cross materials or, even worse, redesign some of our products to support currently-available materials. Such redesign efforts may require certain regulatory and safety agency re-submittals, which may cause further production delays. While we have initiated actions that we believe will limit our exposure to such problems, the dynamic business conditions in many of our markets may challenge the solutions that have been put in place, and issues may recur in the future.

In addition, some of our products are manufactured, assembled and tested by third party subcontractors and contract manufacturers located in Asia. While we have had relationships with many of these third parties in the past, we cannot predict how or whether these relationships will continue in the future. In addition, changes in management, financial viability, manufacturing demand or capacity, or other factors, at these third parties could hurt our ability to have our products manufactured.

Our strategic focus on our custom power supply solution competencies and concurrent cost reduction plans may be ineffective or may limit our ability to compete.

As a result of our strategic focus on custom power supply solutions, we will continue to devote significant resources to developing and manufacturing custom power supply solutions for a large number of customers, where each product represents a uniquely tailored solution for a specific customer's requirements. A failure to meet these customer product requirements or a failure to meet production schedules and/or product quality standards may put us at risk with one or more of these customers. Moreover, changes in market conditions and strategic changes at the direction of our customers may effect their decision to continue purchasing from us. The loss of one or more of our significant custom power supply solution customers could have a material adverse impact on our revenues, business or financial condition.

We have also implemented a series of initiatives designed to increase efficiency and reduce costs. While we believe that these actions will reduce costs, they may not be sufficient to achieve the required operational efficiencies that will enable us to respond more quickly to changes in the market or result in the improvements in our business that we anticipate. In such event, we may be forced to take additional cost-reducing initiatives, which may negatively impact quarterly earnings and profitability as we account for severance and other related costs. In addition, there is the risk that such measures could have long-term adverse effects on our business by reducing our pool of talent, decreasing or slowing improvements in our products or services, making it more difficult for us to respond to customers, limiting our ability to increase production quickly if and when the demand for our solutions increases and limiting our ability to hire and retain key personnel. These circumstances could cause our earnings to be lower than they otherwise might be.

We are dependent upon our ability to attract, retain and motivate our key personnel.

Our success depends on our ability to attract, retain and motivate our key management personnel, including, but not limited to, our President and CEO, our V.P. of Finance, marketing & sales personnel and key engineers necessary to implement our business plan and to grow our business. Competition for certain specific technical and management skill sets is intense. If we are unable to identify and hire the personnel that we need to succeed, or if one or more of our present key employees were to cease to be associated with us, our future results could be adversely affected. Mr. Kohn continues to serve in his role as our President and CEO. However, Mr. Kohn’s employment agreement expired on December 31, 2010, and as of August 12, 2014, Mr. Kohn and the Company have not signed a new employment agreement.

We depend upon a few major customers for a majority of our revenues, and the loss of any of these customers, or the substantial reduction in the quantity of products that they purchase from us, would significantly reduce our revenues and net income.

We currently depend upon a few major original equipment manufacturers ("OEM") and other customers for a significant portion of our revenues. We have experienced a reduction of orders by OEMs and a reduction or cancellation of orders, scaling back of certain activities and workforce layoffs by other customers. The loss of any of these customers, or a substantial reduction in the quantity of products that they purchase from us, would significantly reduce our revenues and net income. Furthermore, diversions in the capital spending of certain of these customers to new network elements have and could continue to lead to their reduced demand for our products, which could in turn, have a material adverse effect on our business and results of operations. If the financial condition of one or more of our major customers should deteriorate, or if they have difficulty acquiring investment capital due to any of these or other factors, a substantial decrease in our revenues would likely result.

We are dependent on the electronic equipment industry, and accordingly will be affected by the impact on that industry by the current economic conditions.

Substantially all of our existing customers are in the electronic equipment industry, and they manufacture products that are subject to rapid technological change, obsolescence, and large fluctuations in demand. This industry is further characterized by intense competition and volatility. The OEMs serving this industry are pressured for increased product performance and lower product prices. OEMs, in turn, make similar demands on their suppliers, such as us, for increased product performance and lower prices. Current economic conditions have affected the entire supply chain, including us. Recently, certain segments of the electronic industry have experienced a significant softening in demand. Such lower demand may effect our customers, in which case the demand for our products may decline and our growth could be adversely affected.

Our reliance on subcontract manufacturers to manufacture certain aspects of our products involves risks, including delays in product shipments and reduced control over product quality.

Since we do not own significant manufacturing facilities, we must rely on, and will continue to rely on, a limited number of subcontract manufacturers to manufacture our power supply products. Our reliance upon such subcontract manufacturers involves several risks, including reduced control over manufacturing costs, delivery times, reliability and quality of components, unfavorable currency exchange fluctuations, and continued inflationary pressures on many of the raw materials used in the manufacturing of our power supply products. If we were to encounter a shortage of key manufacturing components from limited sources of supply, or experience manufacturing delays caused by reduced manufacturing capacity, inability of our subcontract manufacturers to procure raw materials, the loss of key assembly subcontractors, difficulties associated with the transition to our new subcontract manufacturers or other factors, we could experience lost revenues, increased costs, and delays in, or cancellations or rescheduling of, orders or shipments, any of which would materially harm our business.

We outsource, and are dependent upon developer partners for, the development of some of our custom design products.

We made an operational decision to outsource some of our custom design products to numerous developer partners. This business structure will remain in place until the custom design volume justifies expanding our in house capabilities. Incomplete product designs that do not fully comply with the customer specifications and requirements might affect our ability to transition to a volume production stage of the custom designed product where the revenue goals are dependent on the high volume of custom product production. Furthermore, we rely on the design partners' ability to provide high quality prototypes of the designed product for our customer approval as a critical stage to approve production.

We face intense industry competition, price erosion and product obsolescence, which, in turn, could reduce our profitability .

We operate in an industry that is generally characterized by intense competition. We believe that the principal bases of competition in our markets are breadth of product line, quality of products, stability, reliability and reputation of the provider, along with cost. Quantity discounts, price erosion, and rapid product obsolescence due to technological improvements are therefore common in our industry as competitors strive to retain or expand market share. Product obsolescence can lead to increases in un-saleable inventory that may need to be written off and, therefore, could reduce our profitability. Similarly, price erosion can reduce our profitability by decreasing our revenues and our gross margins. In fact, we have seen price erosion over the last several years on most of the products we sell, and we expect additional price erosion in the future.

Our future results are dependent on our ability to establish, maintain and expand our manufacturers' representative OEM relationships and our other distributors.

We market and sell our products through domestic and international OEM relationships and other distribution channels, such as manufacturers' representatives and distributors. Our future results are dependent on our ability to establish, maintain and expand our relationships with OEMs as well as with manufacturers' representatives and distributors to sell our products. If, however, the third parties with whom we have entered into such OEM and other arrangements should fail to meet their contractual obligations, cease doing, or reduce the amount of their, business with us or otherwise fail to meet their own performance objectives, customer demand for our products could be adversely affected, which would have an adverse effect on our revenues.

We may not be able to procure necessary key components for our products, or we may purchase too much inventory or the wrong inventory.

The power supply industry, and the electronics industry as a whole, can be subject to business cycles. During periods of growth and high demand for our products, we may not have adequate supplies of inventory on hand to satisfy our customers' needs. Furthermore, during these periods of growth, our suppliers may also experience high demand and, therefore, may not have adequate levels of the components and other materials that we require to build products so that we can meet our customers' needs. Our inability to secure sufficient components to build products for our customers could negatively impact our sales and operating results. We may choose to mitigate this risk by increasing the levels of inventory for certain key components. Increased inventory levels can increase the potential risk for excess and obsolescence should our forecasts fail to materialize or if there are negative factors impacting our customers’ end markets. If we purchase too much inventory or the wrong inventory, we may have to record additional inventory reserves or write-off the inventory, which could have a material adverse effect on our gross margins and on our results of operations.

We depend on sales of our legacy products for a meaningful portion of our revenues, but these products are mature and their sales will continue to decline.

A relatively large portion of our sales have historically been attributable to our legacy products. We expect that these products may continue to account for a meaningful percentage of our revenues for the foreseeable future. However, these sales are declining. Although we are unable to predict future prices for our legacy products, we expect that prices for these products will continue to be subject to significant downward pressure in certain markets for the reasons described above. Accordingly, our ability to maintain or increase revenues will be dependent on our ability to expand our customer base, to increase unit sales volumes of these products and to successfully, develop, introduce and sell new products such as custom design and value added products. We cannot assure you that we will be able to expand our customer base, increase unit sales volumes of existing products or develop, introduce and/or sell new products.

Our operating results may vary from quarter to quarter.

Our operating results have in the past been subject to quarter-to-quarter fluctuations, and we expect that these fluctuations will continue, and may increase in magnitude, in future periods. Demand for our products is driven by many factors, including the availability of funding for our products in customers' capital budgets. There is a trend for some of our customers to place large orders near the end of a quarter or fiscal year, in part to spend remaining available capital budget funds. Seasonal fluctuations in customer demand for our products driven by budgetary and other concerns can create corresponding fluctuations in period-to-period revenues, and we therefore cannot assure you that our results in one period are necessarily indicative of our revenues in any future period. In addition, the number and timing of large individual sales and the ability to obtain acceptances of those sales, where applicable, have been difficult for us to predict, and large individual sales have, in some cases, occurred in quarters subsequent to those we anticipated, or have not occurred at all. The loss or deferral of one or more significant sales in a quarter could harm our operating results. It is possible that, in some quarters, our operating results will be below the expectations of public market analysts or investors. In such events, or in the event adverse conditions prevail, the market price of our common stock may decline significantly.

Failure of our information technology infrastructure to operate effectively could adversely affect our business.

We depend heavily on information technology infrastructure to achieve our business objectives. If a problem occurs that impairs this infrastructure, the resulting disruption could impede our ability to record or process orders, manufacture and ship in a timely manner, or otherwise carry on business in the normal course. Any such events could cause us to lose customers or revenue and could require us to incur significant expense to remediate.

We are subject to certain governmental regulatory restrictions relating to our international sales.