
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

(Mark One)
 QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2007

OR

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: 000-30939

ACTIVE POWER, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

2128 W. Braker Lane, BK12, Austin, Texas
(Address of principal executive offices)

74-2961657
(I.R.S. Employer
Identification No.)

78758
(Zip Code)

(512) 836-6464
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
The number of shares of common stock, par value of \$0.001 per share, outstanding at July 23, 2007 was 50,353,376.

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PART I – FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements.

Active Power, Inc.
Condensed Consolidated Balance Sheets
(in thousands)

	June 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 6,509	\$ 7,652
Short-term investments in marketable securities	6,039	13,059
Accounts receivable, net	8,169	7,671
Inventories	10,821	10,279
Prepaid expenses and other	353	492
Total current assets	31,891	39,153
Property and equipment, net	6,485	7,341
Other assets	212	232
Total assets	<u>\$ 38,588</u>	<u>\$ 46,726</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,437	\$ 2,663
Accrued expenses	6,559	4,715
Deferred revenue	898	570
Total current liabilities	9,894	7,948
Long term liabilities	25	—
Stockholders' equity:		
Common stock	50	50
Treasury stock	(5)	(5)
Additional paid-in capital	244,569	243,519
Accumulated deficit	(215,835)	(204,765)
Other accumulated comprehensive income	(110)	(21)
Total stockholders' equity	28,669	38,778
Total liabilities and stockholders' equity	<u>\$ 38,588</u>	<u>\$ 46,726</u>

See accompanying notes.

Active Power, Inc.
Condensed Consolidated Statements of Operations and Comprehensive Loss

(in thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Product Revenue	\$ 7,725	\$ 4,835	\$ 12,996	\$ 9,879
Service and spares revenue	1,457	631	2,159	1,156
Total revenue	<u>9,182</u>	<u>5,466</u>	<u>15,155</u>	<u>11,035</u>
Cost of product revenue	6,469	5,022	11,380	10,162
Cost of service and spares revenue	1,166	567	1,891	1,143
Total cost of revenue	<u>7,635</u>	<u>5,589</u>	<u>13,271</u>	<u>11,305</u>
Gross profit (loss)	1,547	(123)	1,884	(270)
Operating expenses:				
Research and development	1,326	2,051	2,910	4,289
Selling and marketing	2,621	2,621	5,246	5,306
General and administrative	2,456	1,973	5,207	3,626
Total operating expenses	<u>6,403</u>	<u>6,645</u>	<u>13,363</u>	<u>13,221</u>
Operating loss	(4,856)	(6,768)	(11,479)	(13,491)
Interest income	159	382	360	776
Other income (expense)	51	253	49	332
Net loss	<u>\$ (4,646)</u>	<u>\$ (6,133)</u>	<u>\$ (11,070)</u>	<u>\$ (12,383)</u>
Net loss per share, basic & diluted	\$ (0.09)	\$ (0.12)	\$ (0.22)	\$ (0.25)
Shares used in computing net loss per share, basic & diluted	50,090	49,648	50,089	49,516
Comprehensive loss:				
Net loss	\$ (4,646)	\$ (6,133)	\$ (11,070)	\$ (12,383)
Translation gain (loss) on subsidiaries in foreign currencies	38	(3)	(106)	(3)
Change in unrealized gain (loss) on investments in marketable securities	5	13	17	22
Comprehensive loss	<u>\$ (4,603)</u>	<u>\$ (6,123)</u>	<u>\$ (11,159)</u>	<u>\$ (12,364)</u>

See accompanying notes.

Active Power, Inc.
Condensed Consolidated Statements of Cash Flows

(in thousands)
(Unaudited)

	Six Months Ended June 30	
	2007	2006
Operating activities		
Net loss	\$(11,070)	\$(12,383)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	1,001	1,051
Change in allowance for doubtful accounts	(31)	—
Accretion of premium/discount on marketable securities	(17)	(48)
Loss on disposal of fixed assets	288	—
Stock-based compensation	1,045	1,782
Changes in operating assets and liabilities:		
Accounts receivable	(468)	1,686
Inventories	(542)	(3,751)
Prepaid expenses and other assets	158	189
Accounts payable	(226)	688
Accrued expenses	1,845	(297)
Deferred revenue	328	160
Long term liabilities	25	—
Net cash used in operating activities	<u>(7,664)</u>	<u>(10,923)</u>
Investing activities		
Purchases of marketable securities	(246)	(9,875)
Sales/maturities of marketable securities	7,300	25,947
Purchases of property and equipment	(433)	(1,369)
Net cash provided by investing activities	<u>6,621</u>	<u>14,703</u>
Financing activities		
Net proceeds from issuance of common stock	6	2,518
Net cash provided by financing activities	<u>6</u>	<u>2,518</u>
Translation gain on subsidiaries in foreign currencies	(106)	(3)
Change in cash and cash equivalents	(1,143)	6,295
Cash and cash equivalents, beginning of period	7,652	7,590
Cash and cash equivalents, end of period	<u>\$ 6,509</u>	<u>\$ 13,885</u>

See accompanying notes.

Active Power, Inc.
Notes to Condensed Consolidated Financial Statements
June 30, 2007
(Unaudited)

1. Significant Accounting Policies

Basis of presentation: Active Power, Inc. and its subsidiaries (hereinafter referred to as “we”, “Active Power” or the “Company”) design manufacture and market power quality solutions and Uninterruptible Power Supply (UPS) systems to enable business continuity in the event of power disturbances. Our solutions provide ride-through, or temporary, power for the majority of power disturbances such as voltage sags and surges, and bridge the gap between a utility outage and restoration of power, or the time required to switch to generator power. We offer a range of patented flywheel energy storage systems that provide an alternative for lead-acid batteries used in conventional power quality installations. We have recently broadened our product offerings with a battery-free extended runtime technology that utilizes thermal and compressed air storage to provide backup power for minutes to hours depending on the application. We sell our products globally through direct and Original Equipment Manufacturer (“OEM”) channels. Our current principal markets are North America and Europe, Middle East and Africa (“EMEA”).

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and include the accounts of the Company and its consolidated subsidiaries. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company and its consolidated results of operations and cash flows. These interim financial statements should be read in conjunction with the financial statements and accompanying notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006.

Recently issued accounting standards: In September 2006 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. The standard also responds to investors’ requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations.

In February 2007, FASB issued Statement of Financial Accounting Standards (SFAS) 159, “The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115”. SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the effect that the adoption of SFAS 159 will have on its financial position and results of operations.

2. Supplemental Balance Sheet Information

Receivables

Accounts receivable consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Trade receivables	\$ 9,494	\$ 9,027
Allowance for doubtful accounts	(1,325)	(1,356)
	<u>\$ 8,169</u>	<u>\$ 7,671</u>

Inventory

We state inventories at the lower of cost or market, using the first-in-first-out-method (in thousands):

	June 30, 2007	December 31, 2006
Raw materials	\$ 6,937	\$ 6,650
Work in process and finished goods	4,215	3,999
Allowances for obsolescence	(331)	(370)
	<u>\$10,821</u>	<u>\$ 10,279</u>

Included in inventory at June 30, 2007 is \$4.4 million of inventory relating exclusively to our CoolAir family of products. We began selling this product in 2006. If we are unable to sell sufficient quantities of our finished CoolAir products or our sales do not meet our expectations, we may need to record an impairment charge for some or all of that amount.

Property and Equipment

Property and equipment consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Equipment	\$ 9,661	\$ 9,438
Computers and software	2,584	2,534
Demonstration units	1,077	1,081
Furniture and fixtures	331	331
Leasehold improvements	7,066	7,066
Construction in progress	149	261
	<u>20,868</u>	<u>20,711</u>
Accumulated depreciation	(14,383)	(13,370)
	<u>\$ 6,485</u>	<u>\$ 7,341</u>

Accrued Expenses

Accrued expenses consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Compensation and benefits	\$ 1,278	\$ 1,418
Warranty liability	644	734
Federal, state, property and sales taxes	749	845
Professional fees	2,829	495
Other	1,059	1,223
	<u>\$6,559</u>	<u>\$ 4,715</u>

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Warranty Liability

Generally, the warranty period for our power quality products is 12 months from the date of commissioning or 18 months from the date of shipment from Active Power, whichever period is shorter. We provide for the estimated cost of product warranties at the time revenue is recognized and this accrual is contained in accrued expenses on the accompanying balance sheet.

Changes in our warranty liability are presented in the following table (in thousands):

Balance at December 31, 2006	\$ 734
Warranty expense	30
Warranty charges incurred	(120)
Balance at June 30, 2007	\$ 644

3. **Net Loss Per Share**

The following table sets forth the computation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net loss	\$ (4,646)	\$ (6,133)	\$ (11,070)	\$ (12,383)
Basic and diluted:				
Weighted-average shares of common stock Outstanding	50,090	49,648	50,089	49,516
Shares used in computing net loss per share, basic and diluted	50,090	49,648	50,089	49,516
Net loss per share, basic and diluted	\$ (0.09)	\$ (0.12)	\$ (0.22)	\$ (0.25)

Our calculation of diluted loss per share excludes 5,400,995 and 6,445,341 shares of common stock issuable upon exercise of employee stock options as of June 30, 2007 and 2006, respectively, because their inclusion in the calculation would be anti-dilutive. As of June 30, 2007 and 2006, there was no common stock subject to repurchase.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with, and is qualified in its entirety to, the financial statements and notes thereto included in Item 1 of this Form 10-Q and the financial statements and notes thereto and our Management’s Discussion and Analysis of Financial Condition and Results of Operation for the year ended December 31, 2006 included in our 2006 Annual Report on Form 10-K. This report contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties. Our expectations with respect to future results of operations that may be embodied in oral and written forward-looking statements, including any forward looking statements that may be included in this report, are subject to risks and uncertainties that must be considered when evaluating the likelihood of our realization of such expectations. Our actual results could differ materially. The words “believe,” “expect,” “intend,” “plan,” “project,” “will” and similar phrases as they relate to us are intended to identify such forward-looking statements. In addition, please see the “Risk Factors” in Part 1, Item 1A in our 2006 Annual Report on Form 10-K for a discussion of items that may affect our future results.

Overview

We design, manufacture and market efficient, reliable and green power quality solutions and Uninterruptible Power Supply (UPS) systems to enable business continuity in the event of power disturbances. Our solutions provide ride-through, or temporary, power for the majority of power disturbances such as voltage sags and surges, and bridge the gap between a utility outage and restoration of power, or the time required to switch to generator power. Our products are designed to be environmentally friendly compared to existing solutions without compromising functionality, efficiency or cost. We have shipped over 1,600 flywheels or more than 400 megawatts of our products to businesses in over 40 countries since we were founded in 1992.

Our patented flywheel energy storage systems store kinetic energy by constantly spinning a compact steel wheel (flywheel) driven from utility power in a low friction environment. When the utility power used to spin the flywheel fluctuates or is interrupted, the flywheel’s inertia causes it to continue spinning. The resulting kinetic energy of the spinning flywheel generates electricity known as “bridging power” for short periods until utility power is fully restored or a backup electricity generator starts and takes over generating longer term power in the case of an extended electrical outage. We believe that our flywheel products provide many advantages over traditional battery-based systems, including substantial space savings, higher power densities, “green” energy storage and power efficiencies as high as 98% that reduce total operating costs. We offer our flywheel products with load capabilities from 130 kVA to 3,600 kVA, while typically targeting power density applications above 200 kVA since the majority of these customers already have back-up generators. We market our flywheel products under the brand name CleanSource®. CleanSource DC is a non-chemical replacement for lead-acid batteries used for bridging power. Utilizing our flywheel energy storage technology, the CleanSource DC is a stand-alone, direct current (DC) product that is compatible with all major brands of uninterruptible power supplies (UPS). We built on the technological success of CleanSource DC by creating a battery-free UPS, CleanSource UPS, which integrates the UPS electronics and our flywheel energy storage system into one compact cabinet. CleanSource UPS represents the majority of our current revenue. The CleanSource UPS is also marketed by Caterpillar Inc. under the brand name “Cat® UPS”. Combining our CleanSource UPS with a generator provides customers with complete short and long-term protection in the event of a power disturbance. We sell our CleanSource flywheel products to commercial and industrial customers across a variety of vertical markets, including manufacturing, technology, communications, utilities, healthcare, banking and military and in all major geographic regions of the world, but particularly in North America and Europe.

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To address the requirements of customers without backup generators that require protection from utility disturbances, we have also developed a patented extended runtime product that we call CoolAir™ DC. We initially have targeted CoolAir DC at lower power levels than our flywheel products, and it is sold as a minute-for-minute replacement for lead-acid batteries. CoolAir DC can provide backup power for several minutes to hours depending on the customer application. CoolAir DC utilizes mature thermal and compressed air storage (TACAS) technologies combined in a proprietary manner to produce backup power during an electrical disturbance. This product discharges cool air as a by-product of its operation that also can be used by customers during an electrical disturbance as a source of backup cooling. In addition to offering a DC-only solution, when customers desire a complete backup solution with an extended runtime, we have introduced the CoolAir UPS that couples our CoolAir DC product with a third-party double-conversion UPS.

Our primary sales channels in North America have traditionally been through our OEM partners, Caterpillar, Inc. and Eaton Electrical (formerly known as PowerWare). Since 2005 we have developed additional sales channels in North America including direct sales employees and a network of manufacturer's representatives. Direct sales tend to improve our relationships with clients, improve our gross margins and add service and other revenue opportunities.

Our primary sales channels in Europe, Middle East and Asia (EMEA) include selling directly to end users and indirectly through select value added resellers (VARs). We also provide services including engineering, installation, start-up, monitoring, and repair for our products under contracts with our customers.

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The following tables set forth our condensed consolidated results of operations data, including data as a percentage of total revenue, for the periods indicated:

Three-months ended June 30:

(\$ in thousands)	Three months ended June 30,				Variance 2007 vs. 2006	
	2007	% of total revenue	2006	% of total revenue	\$	%
Product revenue	\$ 7,725	84%	\$ 4,835	88%	\$2,890	60%
Service and spares revenue	1,457	16%	631	12%	826	131%
Total revenue	<u>9,182</u>	100%	<u>5,466</u>	100%	3,716	68%
Cost of product revenue	6,469	70%	5,022	92%	1,447	29%
Cost of service and spares revenue	1,166	13%	567	10%	599	106%
Total cost of revenue	<u>7,635</u>	83%	<u>5,589</u>	102%	2,046	37%
Gross profit (loss)	1,547	17%	(123)	(2%)	1,670	NM
Operating expenses:						
Research and development	1,326	14%	2,051	38%	(725)	(35)%
Selling and marketing	2,621	29%	2,621	48%	—	—
General and administrative	2,456	27%	1,973	36%	483	24%
Total operating expenses	<u>6,403</u>	70%	<u>6,645</u>	122%	(242)	(4)%
Operating loss	(4,856)	(53%)	(6,768)	(124%)	1,912	28%
Interest income	159	2%	382	7%	(223)	(58)%
Other income (expense)	51	1%	253	5%	(202)	(80)%
Net loss	<u>\$ (4,646)</u>	(51%)	<u>\$ (6,133)</u>	(112%)	\$ 1,487	24%

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Six-months ended June 30:

(\$ in thousands)	Six months ended June 30,				Variance 2007 vs. 2006	
	2007	% of total revenue	2006	% of total revenue	\$	%
Product revenue	\$ 12,996	86%	\$ 9,879	90%	\$ 3,117	32%
Service and spares revenue	2,159	14%	1,156	10%	1,003	87%
Total revenue	15,155	100%	11,035	100%	4,120	37%
Cost of product revenue	11,380	75%	10,162	92%	1,218	12%
Cost of service and spares revenue	1,891	12%	1,143	10%	748	65%
Total cost of revenue	13,271	88%	11,305	102%	1,966	17%
Gross profit (loss)	1,884	12%	(270)	(2%)	2,154	798%
Operating expenses:						
Research and development	2,910	19%	4,289	39%	(1,379)	(32)%
Selling and marketing	5,246	35%	5,306	48%	(60)	(1)%
General and administrative	5,207	34%	3,626	33%	1,581	44%
Total operating expenses	13,363	88%	13,221	120%	142	1%
Operating loss	(11,479)	(76%)	(13,491)	(122%)	2,012	15%
Interest income	360	2%	776	7%	(416)	(54)%
Other income (expense)	49	—	332	3%	(283)	(85)%
Net loss	<u>\$(11,070)</u>	(73%)	<u>\$(12,383)</u>	(112%)	\$ 1,313	11%

Product revenue. Product revenue consists of sales of our CleanSource power quality products, comprising both UPS and DC product lines, CoolAir family products, and sales of third-party ancillary equipment, such as engine generators, electrical and switchgear products.

The 60% increase in product revenue in our second quarter of 2007 from the same period of 2006 was due to higher sales of our megawatt-class UPS product line and from increased sales of our CleanSource DC products, as well as increased sales of ancillary equipment that we sold along with our major product lines. Strong sales of our 250-900 kVA UPS product family represented 37% of our total product revenue during our second quarter. Our effort to develop direct sales in new markets has led to continued growth from our direct sales channel. When we sell product directly, as compared to through our OEM channels, we typically generate higher prices and better contribution margins as we do not have to offer channel discounts. The average selling price during the quarter was \$69,000 per quarter-megawatt flywheel, compared to \$71,000 over the same period in 2006. This decrease is due to the higher proportion of DC wheels sold in 2007, which typically sell for lower prices. During the quarter ended June 30, 2007 we sold 81 flywheel units compared to 57 in the comparable period of 2006.

The frequency and timing of our larger system sales, including megawatt class UPS products, is more volatile and can result in material changes in period-to-period revenue. Such revenues also occur in periods other than when originally anticipated, which can add to the potential volatility and affect our ability to meet forecasted targets.

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North American sales were 66% of our total revenue for the three-month period ended June 30, 2006 compared to 54% for the same period of 2006, and 60% in the immediately preceding quarter.

Since 2005 we have been increasing the size of our direct sales organization in an effort to expand the territories in which we sell our Active Power branded products. Most of this effort initially was focused in the EMEA market where we now have multiple sales offices. During the first quarter of 2007 we opened our first office in the Asia Pacific region, located in Tokyo. We also plan on expanding into Central America in 2007. Sales of Active Power branded products through our direct and manufacturer's representative channels were 67% of our total revenues for the three-month period ended June 30, 2007 compared to 63% for the same period of 2006. For the six months ended June 30, 2007, sales of Active Power branded products were 71% of total revenues compared to 49% in 2006, reflecting the impact of this direct sales strategy. Direct sales typically have higher profit margins than sales through our OEM channels; therefore, increasing our direct sales channel is expected to result in increased revenue and improved profit margins. We believe sales of our Active Power branded products to government facilities and industrial customers in regions that were not covered by our OEMs will continue to increase over time and will continue to become a larger percentage of our total revenue.

Caterpillar remains our largest OEM partner and largest overall customer and represented 32% of our revenue for the three-month period ended June 30, 2007 compared to 36% of our revenue for the three-month period ended June 30, 2006. We have had recent success with Caterpillar selling our megawatt-class UPS products along with their large engine generators, and expect total revenue from this channel to continue to increase in 2007.

Our products perform well in harsh environments where power quality is particularly poor, which makes them a good fit for industrial countries with a poor power infrastructure and therefore we have focused our direct sales efforts to these customers. Due to the large size of some of our customer orders relative to our current total revenue levels, our quarterly total revenue trend and the proportion of sales made directly by us can be expected to fluctuate quarterly from the amounts recorded so far in 2007. We have also seen and anticipate a further increase in capital spending in data centers where there is a requirement for higher-density power solutions such as flywheels, and believe that this along with our expanding direct sales strategy will result in higher product revenue levels for us in 2007.

Service and spares revenue. Service and spares revenue primarily relates to revenue generated from installation, startup, repairs or reconfigurations of our product or power systems and the sale of spare or replacement parts to our OEM and end-user customers. It also includes revenue associated with the costs of travel of our service personnel. Service and spares revenue increased by 131% for the three-month period ended June 30, 2007 compared to the same prior year period. This increase is primarily due to higher levels of service and contract work from direct product sales that we have made during the last two quarters. For some of these customers we provide a full power solution, including site preparation, installation of an entire power solution and provision of all products required to provide a turnkey product to the end user. Our installation revenue continues to increase as we sell more units. We also are more aggressively selling long-term maintenance contracts to customers in addition to providing repair and maintenance services when requested. We anticipate that service and spares revenue will continue to grow with product revenue and as our installed base of product expands, because as more units are sold to customers, more installation, startup and maintenance services will be required. Where we make sales through our OEM channel it is typical for the OEM to provide these type of services to their end-user customers.

Cost of product revenue. Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment and other costs associated with our assembly and test operations, including costs from having underutilized facilities, shipping costs, warranty costs, and the costs of manufacturing support functions such as logistics and quality

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assurance. The cost of product revenue as a percentage of total product revenue in the three-month period ended June 30, 2007 decreased by 19% compared to the comparable period in 2006 due to the effect of higher selling prices, improved efficiency in our manufacturing operations and material and overhead costs reductions. In addition to more frequently passing component price increases on to customers, we have instituted programs to reduce product and component costs where feasible, and this has resulted in a decrease in materials costs as a percentage of product revenue. We continue to operate a manufacturing facility that has a capacity level significantly greater than our current product revenue levels. A large portion of the costs involved in operating our manufacturing facility are fixed in nature and we incur approximately \$1.2 million to \$1.5 million in unabsorbed overhead each quarter. We reduced our manufacturing staff levels in 2006 and have continued to reduce our overhead levels where feasible. During this quarter we were able to sublease a portion of our manufacturing and office space to help further reduce our manufacturing overhead levels and continue to work on other cost reduction activities that we expect to implement in 2007. We also continue to work on reducing our product costs through design enhancements and modifications, and vendor management programs. We have achieved gross-margin break-even in the last four quarters; however, our accomplishment of gross-margin break even is heavily dependent upon our sales channel mix and the effectiveness of our product pricing to our customers. Our ability to maintain positive product gross margin will depend on multiple factors, including our ability to continue to reduce material costs, improve our sales channel mix in favor of direct sales versus OEM, our ability to increase product prices, and to increase our total revenues to a level that will allow us to improve the utilization of our manufacturing operations.

Items that could impact our ability to further improve our gross margin include: sales product volume and mix, pricing discounts and customer incentives, currency fluctuations, and variations in our product cost and productivity.

Cost of service and spares revenue. Cost of service and spares revenue includes the cost of component parts, as well as labor and overhead of our spare parts, direct costs of installation projects, costs associated with travel and labor used in servicing a unit and unabsorbed overhead from the service group. The cost of service and spares revenue decreased to 80% of service and spares revenue in the three-month period ended of June 30, 2007 compared to 90% in the same period of 2006. This decrease reflects better utilization of our service personnel, improved pricing for service, and higher margins on contract work compared to the prior period.

Research and development. Research and development expense primarily consists of compensation and related costs of employees engaged in research, development and engineering activities, third party consulting and product development activities, as well as an allocated portion of our occupancy costs. Overall our research and development expenses were \$725,000 or 35% lower than the second quarter of 2006, and were \$258,000 or 16% lower than the preceding quarter. The major reason for the decrease from 2006 was due to the effect of headcount reductions that the Company made in the third quarter of 2006, and due to lower project related development costs this year. The prior year expenses included higher prototype and development costs for our CoolAir DC product and costs incurred in paralleling our megawatt-class UPS product. We believe research and development expenses in the second quarter will stay at similar levels to those recorded in the second quarter.

Selling and marketing. Selling and marketing expenses primarily comprise compensation, including variable sales compensation, and related costs for sales and marketing personnel, and related travel, selling and marketing expenses, as well as an allocated portion of our occupancy costs. Sales and marketing costs were the same as the amounts recorded in the second quarter of 2006, and were approximately the same as the immediately preceding quarter. Although the total amount of expenditure has remained relatively constant, the mix of expenditure has changed as we moved marketing and sales personnel and costs away from supporting

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our OEM channels and focused on higher marketing expenditures to support our direct sales force, re-branding of the Company's collateral and other direct sales activities as part of our effort to facilitate more direct sales. As we have added more sales distributors this has increased the amount of sales commissions that we pay, as has the overall increase in revenues. Our total headcount in sales and marketing remains at similar levels to last quarter, although we have changed the composition of our sales team over the last year as we expand our direct sales force. We believe that sales and marketing expenses will increase slightly in the third quarter as we expand into the Asia and central American markets and as our revenue levels increase and our variable compensation increases.

General and administrative. General and administrative expense is primarily comprised of compensation and related costs for executive and administrative personnel, professional fees, and taxes, including property and franchise taxes. General and administrative expenses increased by \$483,000 or 24% from the levels of the same period in 2006 and decreased by 11% or \$295,000 from the immediately preceding quarter. This increase from last year was primarily attributable to \$1.2 million of professional fees incurred with a review of the Company's historical stock option granting procedures that covered the period from 2000 through 2006. This was offset by lower headcount costs compared to 2006 and approximately \$300,000 in legal fees recorded in 2006 relating to litigation that was ultimately settled in December 2006. The decrease from the immediately preceding quarter was due to lower professional fees incurred with the review of historical stock option granting procedures which was substantially completed in the second quarter of 2007. We expect general and administrative expenses to decrease from the current level in the next quarter as we believe most of the work associated with the option review has been completed; however, the amount of professional fees relating to the option review remains unknown and will be influenced by the number and extent of regulatory reviews and/or litigation that may occur as a result of this investigation. The Company is currently in the process of negotiating to settle outstanding tax matters emanating from the option review with the Internal Revenue Service, and will record additional expense to cover tax obligations for certain employees who were affected by the option review who were not responsible for the problematic practices uncovered by this review. We will record these expenses at the time we legally finalize those obligations for our employees. Absent the impact of such expenses from the option review, the level of general and administrative expenses should stay at similar levels.

Interest income. Interest income has decreased from \$382,000 in 2006 to \$159,000 in the three-month periods ended June 30, 2007. This reflects the decrease in our average cash and investments balance compared to the prior year as the Company has used its investments to fund operations. Our average cash and investments balance over the three month period ending June 30, 2007 has decreased by approximately \$20.3 million or 58% compared to the average balance over the comparable period ending June 30, 2006.

Other income (expense). Other income in the corresponding quarter of 2006 included cost recoveries from annual audits of our real estate leases.

Liquidity and Capital Resources

Our principal sources of liquidity as of June 30, 2007 consisted of \$12.5 million of cash and investments. We have primarily funded our operations through public and private placements of our common stock as well as \$10.0 million in development funding received from Caterpillar since 1999, and from our product, service and spares revenue. Although we believe that our cash and investments on hand will be sufficient to fund our operations through at least the middle of 2008, it is likely that the Company will raise additional funds before the end of 2007, either through future equity or debt offerings, in order to continue to fund and grow its business beyond that date and to ensure that we have adequate cash reserves. The Company also entered a letter of intent with its primary banker in July 2007 for the bank to provide a \$5 million revolving line of credit facility against eligible receivables and inventory, to help fund our working capital requirements.

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The following table summarizes the yearly changes in cash used in operating activities:

(\$ in thousands)	Six months ended		Variance	
	June 30,		2007 vs. 2006	
	2007	2006	\$	%
Cash used in operating activities	\$(7,664)	\$(10,923)	\$(3,259)	(30%)

Cash used in operating activities decreased by 30% compared to the same period of 2006. This is primarily attributable to lower operating losses, lower levels of stock-based compensation, a \$2 million increase in accrued liabilities relating to professional fees associated with the stock option review and higher deferred revenue from maintenance contracts. These were offset by increases in receivables from our higher sales levels and higher inventories as we manufacture goods for third quarter shipment. We anticipate cash used in operating activities to increase in the third quarter as we discharge the liabilities from the stock option review, reach settlement of the related income tax liabilities, and record an expected increase in receivables due to anticipated higher revenues.

Investing activities primarily consist of sales and purchases of investments and purchases of property and equipment. Fluctuations in the sale and purchase of investments generally reflect our use of these funds to finance our ongoing operations. Capital expenditures were \$433,000 in the six-month period ending June 30, 2007 compared to \$1.4 million in the same period of 2006.

Funds provided by financing activities during the six-months ended June 30, 2006 reflect proceeds from employee share purchases. The significant decrease in funds from financing activities compared to the comparable period of 2006 is due to the fact that during the second quarter of 2006 we had significantly higher levels of stock option exercises because of a much higher stock price for the Company's common stock.

As noted above, we believe our existing cash and investments balances at June 30, 2007 will be sufficient to meet our cash requirements through at least the next 12 months, although we likely will elect to seek additional funding prior to that time. Beyond the next 12 months, our cash requirements will depend on many factors, including the rate of sales growth, the success of our direct selling strategy, the market acceptance of our products, including the CoolAir DC product family, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the efficiency of our manufacturing processes, and the timing and extent of research and development projects.

Off-Balance Sheet Arrangements

As of June 30, 2007 we have no off-balance sheet arrangements.

Recent Accounting Pronouncements

In September 2006 the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. The standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in

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any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We invest our cash in a variety of financial instruments, including bank time deposits, and taxable variable rate and fixed rate obligations of corporations, municipalities, and local, state and national government entities and agencies. These investments are denominated in U.S. dollars.

Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We believe that our investment policy is conservative, both in terms of the average maturity of investments that we allow and in terms of the credit quality of the investments we hold. We estimate that a 1% decrease in market interest rates would decrease our annual interest income by \$100,000.

Our international sales are made primarily in U.S. dollars. Those sales in currencies other than U.S. dollars can result in translation gains and losses. As we increase sales in foreign markets, we anticipate making more sales denominated in foreign currencies, primarily euro and pounds sterling. Currently, we do not engage in hedging activities for the collection of foreign currency receivables in our international operations. However, we may engage in hedging activities in the future.

Our international business is subject to the typical risks of any international business, including, but not limited to, the risks described in Item 1A – “Risk Factors” in our 2006 Annual Report on Form 10-K. Accordingly, our future results could be materially harmed by the actual occurrence of any of these or other risks.

Item 4. Controls and Procedures

- (a) Evaluation of disclosure controls and procedures. We performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(f) under the Securities Exchange Act of 1934. Based on their evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of June 30, 2007 (the end of the period covered by this Quarterly Report on Form 10-Q) to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.
- (b) Changes in internal control over financial reporting. During the three months ended June 30, 2007 there was no change in our internal control over financial reporting that occurred that has materially affected, or that we believe is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

We voluntarily contacted the United States Securities and Exchange Commission (SEC) regarding the Special Committee's investigation into our stock option granting practices and have agreed to share the results of the Special Committee with the SEC. We have received requests for voluntary production of documents from the SEC and we are fully cooperating with the SEC.

While we believe that we have made appropriate judgments in concluding the correct measurement dates for stock option grants and option modifications, the SEC may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact of past stock option grant measurement date and option modification errors, and there is a risk that any SEC inquiry could lead to circumstances in which we may have to further restate our prior financial statements, or otherwise take actions not currently contemplated. Any such circumstances could also lead to future delays in filing our subsequent SEC reports and possible delisting of our stock from The Nasdaq Global Market. Furthermore, if we are subject to adverse findings in any of these other matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could harm our business, financial condition, results of operations and cash flows.

Additionally, we believe there is a possibility that the matters relating to the investigation by the Special Committee of our Board of Directors into our stock option granting practices and the restatement of our consolidated financial statements for the years 2001 through September 2006 may result in future litigation or formal regulatory inquiries, although we are not aware of any such pending litigation or formal regulatory inquiries.

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Item 1A. Risk Factors

You should carefully consider the risks described in Item 1A of our 2006 Annual Report on Form 10-K before making a decision to invest in our common stock or in evaluating Active Power and our business. The risks and uncertainties described in our 2006 Annual Report on Form 10-K are not the only ones we face. Additional risks and uncertainties that we do not presently know, or that we currently view as immaterial, may also impair our business operations. This report is qualified in its entirety by these risk factors.

The actual occurrence of any of the risks described in our 2006 Annual Report on Form 10-K could materially harm our business, financial condition and results of operations. In that case, the trading price of our common stock could decline.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

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

At our annual meeting of stockholders held on June 28, 2007, our stockholders voted on the following matters:

(1) The election of three Class III directors to serve until our 2010 annual meeting or until their successors have been elected and qualified. The nominees of the board of directors were elected by the following vote:

<u>Class III Director</u>	<u>Shares Voted in Favor</u>	<u>Shares Withheld</u>
Richard E. Anderson	23,138,750	13,439,184
Rodney S. Bond	24,766,967	11,810,967
Benjamin Scott	26,145,630	10,432,304

(2) The approval of the appointment of Ernst & Young LLP as independent auditors for the fiscal year ending December 31, 2007. The appointment was approved by the following vote:

<u>Shares Voted in Favor</u>	<u>Shares Voted Opposed</u>	<u>Shares Abstaining</u>
30,811,321	103,112	5,663,500

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Item 5. Other Information.

None.

Item 6. Exhibits.

The following documents are filed as exhibits to this report:

- 3.1 Amended and Restated Certificate of Incorporation (filed as Exhibit 3.1 to Active Power's IPO Registration Statement on Form S-1 (File No.333-36946))
- 3.2 Second Amended and Restated Bylaws (filed as Exhibit 3.2 to Active Power's Current Report on Form 8-K filed on February 2, 2007)
- 31.1 Rule 13a-15(e)/15d-15(e) Certification of Principal Executive Officer
- 31.2 Rule 13a-15(e)/15d-15(e) Certification of Principal Financial Officer
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this to be signed on its behalf by the undersigned thereunto duly authorized.

ACTIVE POWER, INC.
(Registrant)

July 27, 2007
(Date)

/s/ James A. Clishem
James A. Clishem
President and Chief Executive Officer
(Principal Executive Officer)

July 27, 2007
(Date)

/s/ John K. Penver
John K. Penver
Vice President of Finance, Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)

CERTIFICATIONS

I, James A. Clishem, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 27, 2007

/s/ James A. Clishem

James A. Clishem
President and Chief Executive Officer
(Principal Executive Officer)

CERTIFICATIONS

I, John K. Penver, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 27, 2007

/s/ John K. Penver

John K. Penver

Vice President of Finance, Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending June 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James A. Clishem, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

/s/ James A. Clishem

James A. Clishem
President and Chief Executive Officer
July 27, 2007

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending June 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John K. Penver, Vice President of Finance, Chief Financial Officer and Secretary of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

/s/ John K. Penver

John K. Penver

Vice President of Finance, Chief Financial Officer and Secretary

July 27, 2007