# 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, 2003**

**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:**

# ACTIVE POWER, INC.
**(Exact name of registrant as specified in its charter)**

| **Delaware** | **74-2961657** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **2128 W. Braker Lane, BK12, Austin, Texas** | **78758** |
| **(Address of principal executive offices)** | **(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 an accelerated filer (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 June 30, 2003 was 41,897,193.

ACTIVE POWER, INC.
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**PART I—FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**ACTIVE POWER, INC.**
**BALANCE SHEETS**
(Thousands)

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 60,516 | $ 62,934 |
| Accounts receivable, net | 1,548 | 1,510 |
| Inventories | 4,709 | 6,511 |
| Prepaid expenses and other | 431 | 613 |
| Total current assets | 67,204 | 71,568 |
| Property and equipment, net | 11,504 | 12,095 |
| Investments in marketable securities | 20,183 | 27,110 |
| Total assets | $ 98,891 | $ 110,773 |
| LIABILITIES AND STOCKHOLDERS’ EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 702 | $ 352 |
| Accrued expenses | 3,530 | 3,761 |
| Deferred revenue | 150 | — |
| Total liabilities | 4,382 | 4,113 |
| Stockholders’ equity: | | |
| Common Stock | 42 | 42 |
| Treasury stock | (2) | (2) |
| Deferred stock compensation | (133) | (198) |
| Additional paid-in capital | 214,796 | 214,548 |
| Accumulated deficit | (120,572) | (108,315) |
| Other accumulated comprehensive income | 378 | 585 |
| Total stockholders’ equity | 94,509 | 106,660 |
| Total liabilities and stockholders’ equity | $ 98,891 | $ 110,773 |

*See accompanying notes.*

**ACTIVE POWER, INC.**
**STATEMENTS OF OPERATIONS**

(Thousands, except per share amounts)
(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Revenues: | | | | |
| Product revenue | $ 1,871 | $ 2,101 | $ 3,496 | $ 5,232 |
| Development contract | — | 1,000 | — | 2,000 |
| Total revenue | 1,871 | 3,101 | 3,496 | 7,232 |
| Operating expenses: | | | | |
| Cost of product revenue | 2,881 | 3,764 | 6,172 | 8,330 |
| Cost of development contract | — | 803 | — | 1,543 |
| Research and development | 2,352 | 2,663 | 4,894 | 5,274 |
| Selling, general & administrative | 2,910 | 2,919 | 5,616 | 5,967 |
| Amortization of deferred stock compensation | 33 | 459 | 66 | 1,088 |
| Total operating expenses | 8,176 | 10,608 | 16,748 | 22,202 |
| Operating loss | (6,305) | (7,507) | (13,252) | (14,970) |
| Interest income | 387 | 828 | 1,006 | 1,734 |
| Other income (expense) | (15) | (28) | (11) | (10) |
| Net loss | $ (5,933) | $ (6,707) | $ (12,257) | $ (13,246) |
| Net loss per share, basic & diluted | $ (0.14) | $ (0.16) | $ (0.29) | $ (0.32) |
| Shares used in computing net loss per share, basic & diluted | 41,861 | 41,129 | 41,805 | 40,989 |
| Comprehensive loss: | | | | |
| Net loss | $ (5,933) | $ (6,707) | $ (12,257) | $ (13,246) |
| Unrealized gain (loss) on investments in marketable securities | (88) | 187 | (206) | 292 |
| Comprehensive loss | $ (6,021) | $ (6,520) | $ (12,463) | $ (12,954) |

*See accompanying notes.*

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**ACTIVE POWER, INC.**
**STATEMENTS OF CASH FLOWS**

(Thousands)
(unaudited)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2003 | 2002 |
| **Operating activities** | | |
| Net loss | $ (12,257) | $ (13,246) |
| Adjustments to reconcile net loss to cash used in operating activities: | | |
| Depreciation expense | 1,218 | 1,980 |
| Amortization of deferred stock compensation | 66 | 1,088 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (38) | (732) |
| Inventories | 1,803 | (188) |
| Prepaid expenses and other assets | 181 | (70) |
| Accounts payable | 350 | (2,343) |
| Accrued expenses | (232) | 693 |
| Deferred revenue | 150 | — |
| Net cash used in operating activities | (8,759) | (12,818) |
| **Investing activities** | | |
| Net maturity (purchase) of investments | 6,721 | 2,067 |
| Purchases of property and equipment | (627) | (592) |
| Net cash provided by investing activities | 6,094 | 1,475 |
| **Financing activities** | | |
| Net proceeds from issuance of common stock | 247 | 616 |
| Net cash provided by financing activities | 247 | 616 |
| Change in cash and cash equivalents | (2,418) | (10,727) |
| Cash and cash equivalents, beginning of period | 62,934 | 80,401 |
| Cash and cash equivalents, end of period | $ 60,516 | $ 69,674 |

*See accompanying notes.*

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**Active Power, Inc.**
**Notes to Financial Statements**
**June 30, 2003**
**(unaudited)**

## 1. Organization

Active Power, Inc. was founded in 1992 for the purpose of developing and commercializing advances in the field of electromechanics. Prior to 2000, we devoted our efforts principally to research and development, pursuing patent protection for our innovations, successful production of our initial prototypes, raising capital and pursuing markets for our flywheel-based power quality and energy storage products. In 2000 and 2001, the size and scope of our operations expanded considerably. We raised our level of new product development, increased our manufacturing capabilities and capacity, and added resources in sales and service to strengthen our distribution channels. Since that time, we have concentrated on expanding our core group of products through engineering innovation, reducing the cost of those products and manufacturing them with the quality demanded by our customers.

## 2. Significant Accounting Policies

### Basis of Presentation

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the audited financial statements and accompanying notes thereto included in our Form 10-K for the year ended December 31, 2002. In the opinion of management the financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the results for the periods presented. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. Certain reclassifications have been made to the 2002 financial statements to conform to the 2003 presentation.

### Inventory

Active Power states inventories at the lower of cost or market. Inventories consist of the following (in thousands):

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| Raw materials | $2,309 | $ 2,643 |
| Processed inventory | 2,400 | 3,868 |
| | $4,709 | $ 6,511 |

**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, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Net loss | $ (5,933) | $ (6,707) | $(12,257) | $(13,246) |
| Basic and diluted: | | | | |
| Weighted-average shares of common stock outstanding | 41,877 | 41,192 | 41,824 | 41,057 |
| Weighted-average shares of common stock subject to repurchase | (16) | (63) | (19) | (68) |
| Shares used in computing net loss per share, basic and diluted | 41,861 | 41,129 | 41,805 | 40,989 |
| Net loss per share, basic and diluted | $ (0.14) | $ (0.16) | $ (0.29) | $ (0.32) |

**Recent Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), CONSOLIDATION OF VARIABLE INTEREST ENTITIES. FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We do not believe that the adoption of FIN 46 will have a material impact on our results of operations or financial position.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, AMENDMENT OF STATEMENT 133 ON DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES. SFAS 149 amends SFAS No. 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires that contracts with similar characteristics be accounted for on a comparable basis. The provisions of SFAS 149 are effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. We do not believe that the adoption of SFAS 149 will have a material impact on our results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY. SFAS 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 are effective for financial instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period

beginning after June 15, 2003. We do not believe that the adoption of SFAS 150 will have a material impact on our results of operations or financial position.

**3. Accounting for Stock-Based Compensation**

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of Statement No. 123 (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Net loss—as reported | $ (5,933) | $ (6,707) | $ (12,257) | $ (13,246) |
| Total stock-based compensation cost, net of related tax effects included in the determination of net income as reported | (33) | (459) | (66) | (1,088) |
| The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards | 1,482 | 2,212 | 3,102 | 4,389 |
| Pro forma net loss | $ (7,382) | $ (8,460) | $ (15,293) | $ (16,547) |
| Earnings per share | | | | |
| Basic and diluted—as reported | $ (0.14) | $ (0.16) | $ (0.29) | $ (0.32) |
| Basic and diluted—pro forma | $ (0.18) | $ (0.21) | $ (0.37) | $ (0.40) |

**4. Contingencies**

In March 2002 we were named as defendants in a complaint filed in Michigan state court. The plaintiffs are seeking damages for the alleged breach of a joint venture agreement, the breach of fiduciary duties, the misappropriation of trade secrets, and the commission of other torts relating to this joint venture. Further detail is provided later in this document under the Legal Proceedings section (Item 1) of Part II. The parties met for non-binding mediation in Detroit in May 2003, but failed to resolve the dispute. This proceeding is in the discovery phase, and we are therefore unable to determine the ultimate outcome of this claim at this time.

**Item2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*The following discussion should be read in conjunction with the financial statements appearing elsewhere in this Form 10-Q and in our Form 10-K for the year ended December 31, 2002. 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.*

*Among the important factors which could cause actual results to differ materially include: the potential for significant losses to continue; inability to accurately predict revenue and budget for expenses for future periods; fluctuations in revenue and operating results; a slowing global economy, particularly in the primary markets served by our products, and continued decreases and/or delays in capital spending; limited product offerings; inability to expand and integrate new distribution channels; inability to manage new and existing product distribution relationships; our current dependence on our relationship with Caterpillar; competition; inexperience in manufacturing our products in large quantities; delays in research and development; dependence on sole or limited source suppliers; inability to increase product sales; inventory risks; limited resources; dependence upon key personnel; inability to protect our intellectual property rights, including the possibility of an adverse outcome in the litigation in which we are currently engaged; potential future acquisitions; and the volatility of our stock price regardless of our actual financial performance. The discussion below addresses some of these factors. Additional risks and uncertainties that we are unaware of or that we currently deem immaterial also may become important factors that affect us.*

**Overview**

We design, manufacture and market power quality products that provide the consistent, reliable electric power required by today's digital economy. We believe that we are the first company to commercialize a flywheel energy storage system that provides a highly reliable, low-cost and non-toxic replacement for the lead-acid batteries used in conventional power quality installations. Our first product offering, the CleanSource® DC can replace lead-acid batteries in a conventional UPS system, or complement the batteries and increase their life cycle. The CleanSource DC is compatible with all major UPS brands and sold primarily through Powerware, one of the leading global suppliers of UPS systems, and manufacturers representatives. Leveraging our expertise in this technology we have developed a battery-free uninterruptible power supply (UPS). We sell our UPS through Caterpillar under the Caterpillar brand name, Cat® UPS, as well as directly to end users through manufacturing representatives under the brand name CleanSource® UPS. We sell and distribute all of our products through a variety of channels including our existing OEMs and also through independent power quality representatives to maximize market coverage and penetration. Our products are sold for use in the facilities of companies across many different industries that all share a critical need for reliable, high-quality power, such as broadcasters, hospitals, plastic manufacturers,

semiconductor manufacturers, pharmaceutical manufacturers and data centers. Sales have been spread across many different countries from all regions of the world.

Since 1996, we have focused our efforts and financial resources primarily on the design and development of our CleanSource line of power quality products and on establishing effective distribution channels to market our products. As of June 30, 2003, we had generated an accumulated deficit of $120.6 million and expect to continue to sustain operating losses for the next several quarters. Prior to our initial public offering, we funded our operations primarily through sales of shares of our preferred stock, which resulted in gross proceeds of approximately $42.6 million. Based on the current spending levels and expectations in our current business plan, we believe the proceeds from our August 2000 initial public offering, approximately $138.4 million net of commissions and issuance costs, cash balances on hand prior to August 2000, and cash from product revenue and development contracts will be sufficient to meet our capital requirements through at least the next 24 months. Our cash and investments position at June 30, 2003 was $80.7 million.

Since our inception, a small number of customers have accounted for the majority of our annual sales. In 2002, 2001 and 2000, our business level with Caterpillar and its dealer network accounted for 81%, 87% and 96%, respectively, of our revenue. In 2002, sales to Powerware constituted 12% of our total revenue. In the first six months of 2003, sales to Caterpillar and Powerware accounted for 80% and 5%, respectively, of our total revenue. We expect to continue to be dependent on Caterpillar for a substantial portion of our sales for the next several quarters.

**Critical Accounting Policies and Estimates**

The preparation of financial statements and accompanying notes in conformity with generally accepted accounting principles requires that we make estimates and assumptions that affect the amounts reported. Changes in the facts and circumstances could have a significant impact on the resulting financial statements. We believe the following critical accounting policies affect our more complex judgments and estimates. We also have other policies that we consider to be key accounting policies, such as our policies for revenue recognition; however, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

*Allowance for Doubtful Accounts*

We estimate an allowance for doubtful accounts based on factors related to the credit risk of each customer. Because to date we have sold to a limited number of large customers (e.g., Caterpillar and Powerware), credit losses have been minimal. As we integrate additional distribution channels into our business and begin selling our products to smaller, less established customers, the risk of credit losses may increase. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Inventories*

We state inventories at the lower of cost or market. If actual future demand or market conditions are less favorable than those projected by management, or if product design changes result in excess or obsolete components beyond current expectations, additional inventory write-downs may be required. We evaluate our inventory reserves on a quarterly basis.

*Accrued Warranty Liability*

We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability may be required. We evaluate the reasonableness of our warranty accrual levels on a quarterly basis. In 2003 we began reporting warranty expense in Cost of Goods Sold to emphasize the importance of product quality on overall product costs. Prior to 2003 product warranty costs were accounted for in Sales, General and Administrative expense, and have been reclassified to conform to the current year presentation.

*Marketing Programs Accrual*

We engaged in a marketing program with Caterpillar aimed at increasing the number of dedicated UPS salespeople employed by the Caterpillar dealers. As part of that program, we have agreed, under certain circumstances, to offset some of the first-year expenses of this program. We estimate our liabilities under this program and accrue based on our expected payout. We continually monitor the progress of the program, and based on the success of the dedicated UPS salespeople our actual payments may differ from our estimates.

**Results of Operations**

***Product revenue.*** Product revenue primarily consists of sales of our CleanSource line of power quality products. Sales decreased $230,000, or 11%, to $1.9 million for the three months ended June 30, 2003, from $2.1 million for the three months ended June 30, 2002. For the three months ended June 30, 2003 we sold 28 quarter-megawatt flywheel units compared to 35 units for the same period in 2002. Sales decreased $1.7 million, or 33%, to $3.5 million for the six months ended June 30, 2003, from $5.2 million for the six months ended June 30, 2002. For the six months ended June 30, 2003 we sold 51 quarter-megawatt flywheel units compared to 89 units for the same period in 2002. We believe the decrease in revenue and units shipped was primarily attributable to a reduction in the market for capital equipment, including power quality equipment, due in large part to the overall economic slowdown that has persisted in the United States and globally. The average selling price of our base products has remained relatively flat the last several quarters, but can vary depending on product mix and the level of add-on options purchased by the customer. Our international sales increased to approximately 46% of our product revenue for the three months ended June 30, 2003, compared to approximately 37% in the same period last year, due to an extension of our sales coverage into new regions of Europe and Asia.

We benefited from several inventory-stocking orders by two Caterpillar dealers of approximately 145 units, or $7.5 million during the first nine months of 2001. Since the third quarter of 2001, substantially all of our sales have been to our OEM customers for specifically identified end users. A substantial number of these inventory-stocking units were still held by the two Caterpillar dealers as of June 30, 2003. We believe the number of units in inventory stock at our OEM customers has been declining over the last several quarters, including several units that were sold to end customers during the three months ended June 30, 2003. Although

Active Power has no obligations to its OEM customers for the inventory that they hold, any reduction in these Caterpillar dealers' inventory stocking levels will displace Active Power sales.

***Development contract revenue.*** Development contract revenue consists of funding paid to us by Caterpillar. In 1999 we entered into an agreement with Caterpillar to develop the Cat UPS. As part of that agreement Caterpillar provided us with $5.0 million in funding for the successful completion of several development milestones. In September 2001 we signed an extension to our development agreement with Caterpillar to expand the Cat UPS product line. The extension called for an additional $5.0 million in funding upon successful completion of certain development milestones. Between December 2001 and December 2002 we completed all five milestones and collected and recognized $5.0 million of development funding. Although we continue to pursue partnership opportunities that can broaden our channels to market and assist our product development efforts, we had no development contract revenue in the six months ended June 30, 2003, compared with $1.0 million in the three months ended June 30, 2002 and $2.0 million in the six months ended June 30, 2002. We currently do not have, nor do we anticipate, any agreements that will provide additional development funding.

***Cost of product revenue.*** Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment, product warranty, other costs associated with our assembly and test operations, shipping costs, and the costs of manufacturing support functions such as procurement, logistics and quality assurance. Cost of product revenue decreased approximately $883,000, or 23%, to $2.9 million for the three months ended June 30, 2003, from $3.8 million for the three months ended June 30, 2002. Cost of product revenue decreased approximately $2.1 million, or 26%, to $6.2 million for the six months ended June 30, 2003, from $8.3 million for the six months ended June 30, 2002. This decrease was primarily due to the lower sales in 2003 compared to the same period of 2002. During 2001, we significantly expanded our manufacturing capacity by increasing our manufacturing facilities, in anticipation of future demand for our products. This has increased our fixed manufacturing expense base, which will adversely impact our gross margins until production volumes increase enough to cover the added costs of this increased manufacturing capacity. While our variable product margin (sales less materials, direct labor and warranty expense) was positive in the first six months of 2003, our overall product margin was negative due, in large part, to the underutilization of our indirect manufacturing costs. Over time, we believe gross margins should improve if we can increase product volume, thereby achieving greater economies of scale in production and in purchasing component parts, and introduce additional engineering design savings. We have also taken steps to reduce manufacturing staffing and spending levels given current market and business conditions and manufacturing efficiencies. We believe these efforts, such as a workforce reduction in April 2003, should result in additional product margin improvements in the second half of 2003.

***Cost of development contract.*** Cost of development contract primarily consists of engineering expenses incurred related to the joint development process with Caterpillar, through which we have received development funding in the past. Because we do not have a development contract with Caterpillar at this time, we did not have any development contract funding, nor did we have any corresponding cost of development contract expenses during the six months ended June 30, 2003, compared to $803,000 in the three months ended June 30, 2002, and $1.5 million for the six months ended June 30, 2002.

***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 development activities, as well as an allocated portion of our occupancy costs. Research and development expense decreased approximately $311,000, or 12%, to $2.4 million for the three months ended June 30, 2003, from $2.7 million for the three months ended June 30, 2002. Research and development expense decreased approximately $381,000, or 7%, to $4.9 million for the six months ended June 30, 2003, from $5.3 million for the six months ended June 30, 2002. The decrease in research and development expense was primarily driven by a reduction in development spending on our new 1200 kVA high power UPS product line extension as we near the completion of its development. We believe research and development costs will remain relatively flat the next several quarters but would decrease as a percentage of sales if future sales growth occurs. Over time we expect a shift in our development efforts from our high power 1200 kVA UPS to lower power, extended runtime products will further reduce our project related cost and, in turn, lower our R&D spending levels.

***Selling, general and administrative.*** Selling, general and administrative expense is primarily comprised of compensation and related costs for sales, service, marketing and administrative personnel, selling and marketing expenses, professional fees, and bad debt costs and reserves. Selling, general and administrative expense was essentially flat at $2.9 million for the three months ended June 30, 2003 and the three months ended June 30, 2002. Selling, general and administrative expense decreased approximately $351,000, or 6%, to $5.6 million for the six months ended June 30, 2003, from $6.0 million for the six months ended June 30, 2002. The decrease in selling, general and administrative expense for the six month period was principally due to a reduction in personnel associated with the consolidation of several management and sales positions. We believe that selling, general and administrative expense will remain relatively flat over the next several quarters, but would decrease as a percentage of sales if future sales growth occurs. We expect savings associated with recent staffing reductions to be offset by higher channel support costs associated with establishing and maintaining a new distribution channel, including increased marketing promotions, trade show expenditures, sales and service personnel training, higher legal costs associated with the legal proceedings noted in financial footnote 4 and in Item 1 of Part II below, and increases in directors and officers insurance premiums.

***Amortization of deferred stock compensation.*** Deferred stock compensation is a non-cash expense that reflects the difference between the exercise price of option grants to employees and the estimated fair value of our common stock at the date of grant determined subsequently by us. We are amortizing deferred stock compensation as an operating expense over the vesting periods of the applicable options, which resulted in amortization expense of $33,000 for the three months ended June 30, 2003 and $459,000 for the three months ended June 30, 2002. Amortization expense was $66,000 for the six months ended June 30, 2003 compared to $1.1 million for the six months ended June 30, 2002. The amortization expense has been reduced significantly in recent quarters as the options for which we are amortizing this expense become fully vested and as employees to whom these options were granted leave the company and their unvested options are canceled. We expect this amortization expense to continue to decrease in the future until it is eliminated in the second quarter of 2004.

***Interest income.*** Interest income decreased $441,000, or 53%, to $387,000 for the three months ended June 30, 2003, from $828,000 for the three months ended June 30, 2002. Interest income decreased $728,000, or 42%, to $1.0 million for the six months ended June 30, 2003,

from $1.7 million for the six months ended June 30, 2002. This decrease is attributable to two factors. First, there was a decrease in our average cash and investments balance to $82.5 million for the three-month period ended June 30, 2003, compared to an average cash and investments balance of $101.2 million for the three-month period ended June 30, 2002. Second, the average rate of return on our investments dropped from 3.58% in the second quarter of 2002 to 1.87% in the second quarter in 2003, as interest rates in the financial markets have declined over the past year, and several higher yield securities purchased in early 2002 matured and were reinvested at current market rates.

**Liquidity and Capital Resources**

Our principal source of liquidity as of June 30, 2003 consisted of approximately $80.7 million of cash, cash equivalents and investments in marketable securities. We have primarily funded our operations from the proceeds of our initial public offering in August 2000 of $138.4 million net of underwriting discounts and issuance costs, sales of shares of our preferred stock which resulted in gross proceeds to us of approximately $42.6 million, as well as $10 million in development funding we received from Caterpillar since 1999, and our product revenue. Cash used in operating activities in the three months ended June 30, 2003 was $3.9 million, a $256,000 decrease from the $4.2 million used in the same period of 2002. Cash used in operating activities in the first six months of 2003 was $8.8 million, a $4.0 million decrease from the $12.8 million used in the first six months of 2002. The cash usage in 2002 and 2003 was principally focused on product development of our higher power product platform, the expansion and product cost reductions of our existing UPS product line, and the funding of manufacturing operations and sales and marketing activities to support current revenue and position us for future sales growth.

Capital expenditures in the second quarter of 2003 were approximately $36,000, a $434,000 decrease from the $470,000 used in the same period of 2002. Capital expenditures in the first six months of 2003 were approximately $627,000, a $35,000 increase from the $592,000 used in the first six months of 2002. In the first six months of 2003 our expenditures were principally for the completion of the leasehold improvements to adapt a portion of our manufacturing facility to support the consolidation of our manufacturing, sales, service, marketing, information technology, and administrative functions into one facility. Our expenditures in the first six months of 2002 were limited to leasehold improvements to our engineering testing facilities and other general computer equipment and software for administrative purposes. We expect to spend $250,000 to $500,000 during the remainder of 2003 to enable the consolidation of our engineering and advanced development facilities, as well as to add additional engineering lab equipment, and general computer equipment and software for general corporate purposes.

We believe our existing cash and investments balance at June 30, 2003 will be sufficient to meet our capital requirements through at least the next 24 months, although we might elect to seek additional funding prior to that time. Beyond the next 24 months, our capital requirements will depend on many factors, including the rate of sales growth, the market acceptance of our products, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the rate of expansion of our manufacturing processes, and the timing and extent of research and development projects. Although we are not a party to any agreement or letter of intent with respect to a potential acquisition or merger, we may enter into acquisitions or strategic arrangements in the future, which could also require us to seek additional equity or debt financing.

**Recent Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), CONSOLIDATION OF VARIABLE INTEREST ENTITIES. FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We do not believe that the adoption of FIN 46 will have a material impact on our results of operations or financial position.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, AMENDMENT OF STATEMENT 133 ON DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES. SFAS 149 amends SFAS No. 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires that contracts with similar characteristics be accounted for on a comparable basis. The provisions of SFAS 149 are effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. We do not believe that the adoption of SFAS 149 will have a material impact on our results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY. SFAS 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 are effective for financial instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. We do not believe that the adoption of SFAS 150 will have a material impact on our results of operations or financial position.

**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 approximately $800,000. Because of the nature of the majority of our investments, we do not believe a 1% decline in interest rates would have a material effect on their fair value.

## Risk Factors That May Affect Future Results

*In addition to the other information in this Form 10-Q, the following factors should be considered in evaluating Active Power and our business.*

**We have incurred significant losses and anticipate losses for the next several quarters.**

We have incurred operating losses since our inception and expect to continue to incur losses for the next several quarters. As of June 30, 2003, we had an accumulated deficit of $120.6 million. To date, we have funded our operations principally through the sale of our stock, our product revenue and $10.0 million in development funding payments from Caterpillar. We will need to generate significant additional revenue to achieve profitability, and we cannot assure you that we will ever realize additional revenue at such levels. We also expect to incur product development, sales and marketing and administrative expenses significantly in excess of our product revenue after costs, and, as a result, we expect to continue to incur losses for the next several quarters.

**Due to our limited operating history and the uncertain market acceptance of our products, we may never achieve significant revenue and may have difficulty accurately predicting revenue for future periods and appropriately budgeting for expenses.**

We have generated a total of $41.4 million in product revenue since January 1, 1998, with approximately $1.9 million generated in the three months ended June 30, 2003. We are uncertain whether our products will achieve market acceptance such that our revenue will increase or whether we will be able to achieve significant revenue. Therefore, we have a very limited ability to predict future revenue. Our limited operating experience, the uncertain market acceptance for our products, and other factors that are beyond our control make it difficult for us to accurately forecast our quarterly and annual revenue. However, we use our forecasted revenue to establish our expense budget. Most of our expenses are fixed in the short term or incurred in advance of anticipated revenue. As a result, we may not be able to decrease our expenses, if desired, in a timely manner to offset any revenue shortfall. If our revenue does not increase as anticipated, we will continue to incur significant losses.

**Our business is subject to fluctuations in operating results, which could negatively impact the price of our stock.**

Our product revenue, expense and operating results have varied in the past and may fluctuate significantly in the future due to a variety of factors, many of which are outside of our control. These factors include, among others:

- the timing of orders from our customers and the possibility that these customers may change their order requirements with little or no advance notice to us;
- the rate of adoption of our flywheel-based energy storage system as an alternative to lead-acid batteries;
- the deferral of customer orders in anticipation of new products from us or other providers of power quality systems;
- the ongoing need for short-term power outage protection in traditional UPS systems;
- the uncertainty regarding the adoption of our current and future products, including the CleanSource UPS and CleanSource2 DC products, as well as our other products which are currently under development; and

- the rate of growth of the markets for our products.

**There is a substantial amount of product held as inventory by two members of the Caterpillar dealer network. As other Caterpillar dealers fill their orders for Cat UPS products from that dealer network inventory instead of our factory, our revenue will suffer.**

Two Caterpillar dealers purchased a substantial number of large UPS systems during the first nine months of 2001, of which many have remained in those dealers' inventories rather than be sold to end user customers. As the other Caterpillar dealers fill their Cat UPS orders through this dealer inventory, as opposed to placing orders with Active Power, our revenue will suffer for the next several fiscal quarters. Moreover, failure to replenish the existing inventory of the Caterpillar dealer network could also negatively impact our revenue.

**Our business is dependent on the market for power quality products and the health of the overall economy, and if this market does not expand as we anticipate, if alternatives to our products are successful, or if the downturn in the economy continues to limit capital spending, our business will continue to suffer.**

The market for power quality products is evolving and it is difficult to predict its potential size or future growth rate. Most of the organizations that may purchase our products have invested substantial resources in their existing power systems and, as a result, have been reluctant or slow to adopt a new approach, particularly during a period of reduced capital expenditures. Moreover, our current products are alternatives to existing UPS and battery-based systems and may never be accepted by our customers or may be made obsolete by other advances in power quality technologies. Improvements may also be made to the existing alternatives to our products that could render them less desirable or obsolete. Furthermore, our business depends on capital expenditures by organizations, which tend to decrease when the U.S. or global economy slows. Our business has suffered significantly during the recent economic slowdown, and will continue to suffer until the economy improves and capital expenditures by organizations increase.

**The impact of global economic conditions on our customers may cause us to fail to meet analyst and investors' expectations, which would negatively impact the price of our stock.**

Our operating results can vary significantly based upon the impact of global economic conditions on our customers. More specifically, the macroeconomic environment and capital spending has declined in recent years. While the economic environment is showing signs of improvement we have yet to notice a significant increase in capital expenditures by our customers or potential customers Our operating results depend on the overall demand for power quality products. Because our sales are primarily to major corporate customers whose businesses fluctuate with general economic and business conditions, a softening of demand for power quality products caused by a weakening economy has resulted in decreased revenues. We may be especially prone to this as a result of the relatively high percentage of revenue we have historically derived from the high-tech industry, which was more significantly adversely impacted by the economic decline than other industries. Customers may defer or reconsider purchasing our products if they continue to experience a lack of growth in their business or if the general economy fails to significantly improve.

**We have limited product offerings and our success depends on our ability to develop in a timely manner new and enhanced products that achieve market acceptance.**

To grow our revenue, we must develop and introduce to the market new products and product enhancements in a timely manner. Specifically, our ability to capture significant market share depends on our ability to develop and market extensions to our existing UPS product line at higher and lower power range offerings, and on our ability to develop and market extended runtime products. Even if we are able to develop and commercially introduce new products and enhancements, they may not achieve market acceptance, which would substantially impair our revenue, profitability and overall financial prospects.

**Failure to expand our distribution channels and manage our existing and new product distribution relationships could impede our future growth.**

The future growth of our business will depend in part on our ability to expand our existing relationships with distributors, to identify and develop additional channels for the distribution and sale of our products and to manage these relationships. As part of our growth strategy, we may expand our relationships with distributors and develop relationships with new distributors. We will also look to identify and develop new relationships with additional parties that could serve as an outlet for our products. For example, we recently broadened our sales and distribution channel by offering our products through manufacturer’s representatives throughout North America and internationally. Our inability to successfully execute this strategy, and to integrate and manage our existing OEM channel partners, Caterpillar and Powerware, and our new manufacturer’s representatives could impede our future growth.

**We are heavily dependent on our relationship with Caterpillar, our primary OEM customer. If our relationship is unsuccessful, for whatever reason, our business and financial prospects could suffer.**

If our relationship with Caterpillar is not successful, or if Caterpillar’s distribution of the Cat UPS product is not successful, our business and financial prospects could suffer. During 2002, 2001 and 2000, our business level with Caterpillar and its dealer network accounted for 81%, 87% and 96% of our product revenue, respectively. During the first six months of 2003, our business level with Caterpillar and its dealer network accounted for 80% of our product revenue. Pursuant to our distribution agreement with Caterpillar, they are the exclusive OEM distributor, subject to limited exceptions, of our CleanSource UPS product. Caterpillar is not obligated to purchase any CleanSource UPS units. Through December 31, 2002, pursuant to our development agreements Caterpillar has provided us with $10.0 million in funding to support the development of the Cat UPS product line and other development efforts. In exchange for these payments, Caterpillar received co-ownership of the proprietary rights in this product. Either Caterpillar or we may license to other entities the intellectual property that we jointly own without seeking the consent of the other and the licensing party will solely retain all licensing revenue generated by licensing this intellectual property. However, we may not license the joint intellectual property to specifically identified competitors of Caterpillar until January 1, 2007. Caterpillar may terminate this agreement at any time by giving us 90 days advance written notice.

**We have no experience manufacturing our products in large quantities.**

To be financially successful, we will have to manufacture our products in commercial quantities at acceptable costs while also preserving the quality levels we achieved when manufacturing these products in more limited quantities. This presents a number of technological and engineering challenges for us. We have not previously manufactured our products in high volume. We do not know whether or when we will be able to develop efficient,

low-cost manufacturing capability and processes that will enable us to meet the quality, price, engineering, design and product standards or production volumes required to successfully manufacture large quantities of our products. Even if we are successful in developing our manufacturing capability and processes, we do not know whether we will do so in time to meet our product commercialization schedule or to satisfy the requirements of our customers.

**In 2001 we expanded our manufacturing facility based on anticipated sales volume increases. If we do not achieve these forecasted sales volumes, we will underutilize our manufacturing capacity and our business will suffer.**

In May 2001 we completed a 127,000 square foot facility used for manufacturing and testing our three-phase product line, including our DC and UPS products. In order for us to fully utilize the capacity of the facility and spread out its associated overhead, we must achieve significantly higher sales volumes. We have been unsuccessful at increasing our sales volume following the facility expansion and we may never increase our sales volume to necessary levels. If we do not reach these sales volume levels, or if we cannot sell our products at our suggested prices, our ability to reach profitability will be materially limited.

**Quality problems relating to one or more of our new or existing products could negatively impact the market's acceptance of our products and cause us to miss our revenue goals and/or to incur significant liability.**

Because of the nature of the power quality and reliability market, quality problems attributable to the CleanSource DC and CleanSource UPS product lines could significantly affect the market's perception of our technology and slow or limit their acceptance. This would substantially impair our revenue prospects. Moreover, quality problems for our product lines could cause us to delay or cease shipments of products, or recall products, thus impairing our revenue or cost targets. In addition, while we seek to limit our liability as a result of product failures or defects through warranty and other limitations, if one of our products fails then a customer could suffer a significant loss and seek to hold us responsible for that loss.

**We are subject to increased inventory risks and costs because we outsource the manufacturing of components of our products in advance of binding commitments from our customers to purchase our products.**

To assure the availability of our products to our customers, we outsource the manufacturing of components prior to the receipt of purchase orders from customers based on their forecasts of their product needs and internal product sales revenue forecasts. However, these forecasts do not represent binding purchase commitments and we do not recognize revenue for such products until the product is shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated revenue. As demand for our products may not materialize, this product delivery method subjects us to increased risks of high inventory carrying costs, obsolescence and excess, and may increase our operating costs. In addition, we may from time to time make design changes to our products, which could lead to obsolescence of inventory.

**We depend on sole source and limited source suppliers for certain key components, and if we are unable to buy these components on a timely basis, our delayed ability to deliver our products to our customers may result in reduced revenue and lost sales.**

At current sales levels we purchase several component parts from sole source and limited source suppliers. As a result, if our suppliers receive excess demand for their products, we may receive a low priority for order fulfillment as large volume customers will receive priority. If we are delayed in acquiring components for our products, the manufacture and shipment of our products also will be delayed. We are, however, continuing to enter into long-term agreements with our sole suppliers and other key suppliers, when available, using a rolling sales volume forecast to stabilize component availability. Lead times for ordering materials and components vary significantly and depend on factors such as specific supplier requirements, contract terms, the extensive production time required and current market demand for such components. Some of these delays may be substantial. As a result, we purchase several components in large quantities to protect our ability to deliver finished products. If we overestimate our component requirements, we may have excess inventory, which will increase our costs. If we underestimate our component requirements, we will have inadequate inventory, which will delay our manufacturing and render us unable to deliver products to customers on scheduled delivery dates. If we are unable to obtain a component from a supplier or if the price of a component has increased substantially, we may be required to manufacture the component internally, which will result in delays. Manufacturing delays could negatively impact our ability to sell our products and could damage our customer relationships.

**We depend on key personnel to manage our business and develop new products in a rapidly changing market, and if we are unable to retain our current personnel and hire additional personnel, our ability to develop and sell our products could be impaired.**

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. There is a limited supply of skilled employees in the power quality marketplace. The decline in our stock price has resulted in a substantial number of "underwater" stock options, which may cause certain of our employees to seek employment elsewhere as a result of this decreased financial incentive. In April 2003, we reduced our workforce throughout all departments of the Company. If we experience significant demand for our products in the near term, we may have difficulty hiring and training qualified new employees to meet this demand. If we are unable to retain the personnel we currently employ, or if we are unable to quickly replace departing employees, our operations and new product development may suffer.

**We are a relatively small company with limited resources compared to some of our current and potential competitors, and competition within our markets may limit our sales growth.**

The markets for power quality and power reliability are intensely competitive. There are many companies engaged in all areas of traditional and alternative UPS and backup systems in the United States and abroad, including, among others, major electric and specialized electronics firms, as well as universities, research institutions and foreign government-sponsored companies. There are many companies that are developing flywheel-based energy storage systems and flywheel-based power quality systems. We also compete indirectly with companies that are developing other types of power technologies, such as superconducting magnetic energy storage, ultra-capacitors and dynamic voltage restorers.

Many of our current and potential competitors have longer operating histories, significantly greater resources, broader name recognition and a larger customer base than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater

resources to the development, promotion and sale of their products than we can to ours, which would allow them to respond more quickly than us to new or emerging technologies or changes in customer requirements. In addition, some of our current and potential competitors have established supplier or joint development relationships with our current or potential customers. These competitors may be able to leverage their existing relationships to discourage these customers from purchasing products from us or to persuade them to replace our products with their products. Increased competition could decrease our prices, reduce our sales, lower our margins, or decrease our market share. These and other competitive pressures could prevent us from competing successfully against current or future competitors and could materially harm our business.

**If we are unable to protect our intellectual property, we may be unable to compete.**

Our products rely on our proprietary technology, and we expect that future technological advancements made by us will be critical to sustain market acceptance of our products. Therefore, we believe that the protection of our intellectual property rights is, and will continue to be, important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and business partners and control access to and distribution of our software, documentation and other proprietary information. Despite these efforts, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where applicable laws may not protect our proprietary rights as fully as in the United States. In addition, the measures we undertake may not be sufficient to adequately protect our proprietary technology and may not preclude competitors from independently developing products with functionality or features similar to those of our products.

**Our efforts to protect our intellectual property may cause us to become involved in costly and lengthy litigation, which could seriously harm our business.**

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights. For example, we were named in a lawsuit, along with Joe Pinkerton, our chairman and chief executive officer, alleging the misappropriation of trade secrets that we describe in further detail in “Legal Proceedings” in Item 1 of Part II below. We may become involved in additional litigation in the future to protect our intellectual property or defend allegations of infringement asserted by others. Legal proceedings, including the current lawsuit in which we are named as a defendant, could subject us to significant liability for damages or invalidate our intellectual property rights. Any litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert management’s time and attention. Any potential intellectual property litigation also could force us to take specific actions, including:

- cease selling our products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology or trademark, which license may not be available on reasonable terms, or at all; or
- redesign those products that use infringing intellectual property or cease to use an infringing trademark.

**Any acquisitions we make could disrupt our business and harm our financial condition.**

Although we are not currently negotiating any material business or technology acquisitions, as part of our growth strategy, we may review opportunities to acquire other businesses or technologies that would complement our current products, expand the breadth of our markets or enhance our technical capabilities. We have no experience in making acquisitions. Acquisitions entail a number of risks that could materially and adversely affect our business and operating results, including:

- problems integrating the acquired operations, technologies or products with our existing business and products;
- potential disruption of our ongoing business and distraction of our management;
- difficulties in retaining business relationships with suppliers and customers of the acquired companies;
- difficulties in coordinating and integrating overall business strategies, sales and marketing, and research and development efforts;
- the maintenance of corporate cultures, controls, procedures and policies;
- risks associated with entering markets in which we lack prior experience; and
- potential loss of key employees.

**We may require substantial additional funds in the future to finance our product development and commercialization plans.**

Our product development and commercialization schedule could be delayed if we are unable to fund our research and development activities or the development of our manufacturing capabilities with our revenue and our cash on hand. We expect that our current cash and investments, together with our other available sources of working capital, will be sufficient to fund development activities for at least 24 months. However, unforeseen delays or difficulties in these activities could increase costs and exhaust our resources prior to the full commercialization of our products under development. We do not know whether we will be able to secure additional funding, or funding on terms acceptable to us, to continue our operations as planned. If financing is not available, we may be required to reduce, delay or eliminate certain activities or to license or sell to others some of our proprietary technology.

**Provisions in our charter documents and of Delaware law, and provisions in our agreements with Caterpillar, could prevent, delay or impede a change in control of our company and may depress the market price of our common stock.**

Provisions of our certificate of incorporation and bylaws could have the effect of discouraging, delaying or preventing a merger or acquisition that a stockholder may consider favorable. Additionally, in December of 2001 our board of directors approved a stockholder rights plan, which would require a potential acquiror to negotiate directly with our board of directors regarding any planned acquisition. We also are subject to the anti-takeover laws of the State of Delaware, which may further discourage, delay or prevent someone from acquiring or merging with us. In addition, our agreement with Caterpillar for the distribution of CleanSource UPS provides that Caterpillar may terminate the agreement in the event we are acquired or undergo a change in control. The possible loss of our most significant customer could be a significant deterrent to possible acquirers and may substantially limit the number of possible

acquirers. All of these factors may decrease the likelihood that we would be acquired, which may depress the market price of our common stock.

**Our stock price may be volatile.**

From January 1, 2001 through June 30, 2003, the market price of our common stock has fluctuated between $0.98 and $31.50 per share. The market price of our common stock can be expected to fluctuate significantly in response to numerous factors, some of which are beyond our control, including the following:

- actual or anticipated fluctuations in our operating results;
- changes in financial estimates by securities analysts or our failure to perform in line with such estimates;
- changes in market valuations of other technology companies, particularly those that sell products used in power quality systems;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- introduction of technologies or product enhancements that reduce the need for flywheel energy storage systems;
- the loss of one or more key OEM customers;
- inability to expand our distribution channels;
- departures of key personnel; and
- changing external capital market conditions.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk

This information is included in the section captioned “Quantitative and Qualitative Disclosures About Market Risk” in Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

## Item 4. Controls and Procedures

We performed an evaluation under the supervision and with the participation of our management, including our CEO and CFO, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on their evaluation, Active Power’s Chief Executive Officer and Chief Financial Officer have concluded the Company’s disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934) are effective as of June 30, 2003 (a date within 90 days of the filing of this Quarterly Report on Form 10-Q).

There have been no significant changes in our internal controls or other factors that could significantly affect internal controls subsequent to June 30, 2003, including any corrective actions with regard to significant deficiencies and material weaknesses.

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ACTIVE POWER, INC.

## PART II—OTHER INFORMATIO N

**Item 1. Legal Proceeding s.**

On March 25, 2002, we, along with Joseph F. Pinkerton, III, our chairman and chief executive officer, Pinkerton Generator, Inc. (a corporation in which Mr. Pinkerton was an officer, director and the primary shareholder), and Caterpillar Inc. were named as defendants in a complaint filed in Michigan state court in the Circuit Court for the County of Wayne. The plaintiffs, Magnex Corporation, Enigma Corporation and Bergeron Corporation, and their individual principals, are seeking damages for: alleged breach of a joint venture agreement dated June 23, 1989, which was entered into by and among Pinkerton Generator, Inc., Magnex Corp. and Enigma Corp.; breach of fiduciary duties; misappropriation of trade secrets; and the commission of other torts relating to this joint venture. Neither Active Power nor any of its predecessors in interest was a party to the joint venture agreement. We were served with the Original Complaint and Amended Complaint on April 19, 2002. The parties met for non-binding mediation in Detroit in May 2003, but failed to resolve the dispute. This proceeding is in the discovery phase, and we are therefore unable to determine the ultimate outcome of this claim at this time.

**Item 2. Changes in Securities and Use of Proceeds.**

Not applicable.

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

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

At our annual meeting of stockholders held on May 1, 2003, our stockholders voted on the following matters:

(1) The election of one Class III director to serve until our 2006 annual meeting or until his successor has been elected and qualified. The nominee of the board of directors was elected by the following vote:

| Class III Director | Shares Voted in Favor | Shares Withheld |
|---|---|---|
| Joseph F. Pinkerton, III | 32,880,146 | 2,149,291 |

The following is a list of our other directors whose term of office continued after our annual meeting:

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Ÿ Our Class I directors, Richard E. Anderson, Rodney S. Bond and Benjamin L. Scott, who will continue to serve until our 2004 annual meeting or until his successor has been elected and qualified; and

Ÿ Our Class II directors, Jan H. Lindelow and Terrence L. Rock, who will continue to serve until our 2005 annual meeting or until his successor has been elected and qualified.

(2) The approval of the appointment of Ernst & Young LLP as independent auditors for the fiscal year ending December 31, 2003. The appointment was approved by the following vote:

| Shares Voted in Favor | Shares Voted Opposed | Shares Abstaining |
|---|---|---|
| 34,817,360 | 196,452 | 15,624 |

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits and Reports on Form 8-K.**

(a) Exhibits

99.1 Exhibit 31.1—Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.

99.2 Exhibit 31.2—Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.

99.3 Exhibit 32.1—Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002

99.4 Exhibit 32.2—Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002

(b) During the fiscal quarter ended June 30, 2003, Active Power filed the following current report on Form 8-K:

- We filed a Form 8-K dated April 24, 2003 announcing a press release describing the results of operations for our fiscal quarter ended March 31, 2003

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**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.**<br>(Registrant) |
|---|---|
| July 24, 2003<br>(Date) | /s/ Joseph F. Pinkerton, III<br>Joseph F. Pinkerton, III<br>Chairman of the Board, President and<br>Chief Executive Officer |
| July 24, 2003<br>(Date) | /s/ David S. Gino<br>David S. Gino<br>Chief Operating Officer, Vice President of Finance,<br>Chief Financial Officer and Secretary<br>(Principal Accounting Officer) |

**Exhibit 31.1—Chief Executive Officer Certification**

I, Joseph F. Pinkerton III, President and Chief Executive Officer of Active Power, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Active Power, Inc. (the "Registrant");

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)) 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) 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

(c) 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 the 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.

Dated: July 24, 2003

/s/ Joseph F. Pinkerton, III

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Joseph F. Pinkerton, III
Chairman of the Board, President and Chief Executive Officer
(Principal Executive Officer)

**Exhibit 31.2—Chief Financial Officer Certification**

I, David S. Gino, Vice President, Chief Operating Officer and Chief Financial Officer of Active Power, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Active Power, Inc. (the "Registrant");

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) 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

(c) 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 the 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.

Dated: July 24, 2003

/s/ David S. Gino

David S. Gino
Vice President, Chief Operating Officer and Chief Financial Officer
(Principal Financial and Accounting Officer)

**Exhibit 32.1—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 10Q of Active Power, Inc. (the “Company”) for the period ending June 30, 2003, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Joseph F. Pinkerton, III, Chairman of the Board, 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) 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 as of the dates and for the periods expressed in the Report.

/s/ Joseph F. Pinkerton, III

Joseph F. Pinkerton, III
Chairman of the Board, President
and Chief Executive Officer
July 24, 2003

**Exhibit 32.2—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 of Active Power, Inc. (the “Company”) on Form 10-Q for the period ending June 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, David S. Gino, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C.ss. 1350, as adopted pursuant to ss. 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) 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 as of the dates and for the periods expressed in the Report.

/s/ David S. Gino

David S. Gino
Vice President, Chief Operating Officer
and Chief Financial Officer
July 24, 2003