POWER INTEGRATIONS INC
Form 10-Q
August 01, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2013

or

o 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 0-23441

POWER INTEGRATIONS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of Incorporation or organization)	94-3065014 (I.R.S. Employer Identification No.)

5245 Hellyer Avenue, San Jose, California, 95138
(Address of principal executive offices) (Zip code)
(408) 414-9200
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark whether the registrant submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Class	Shares Outstanding at July 19, 2013
Common Stock, $.001 par value	29,603,997

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words “would”, “could”, “will”, “may”, “expect”, “believe”, “should”, “anticipate”, “if”, “future”, “intend”, “plan”, “estimate”, “potential”, “targets”, “seek” or “continue” and si phrases, including the negatives of these terms, or other variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under Item 1A of Part II — “Risk Factors,” Item 2 of Part I — “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this Quarterly Report on Form 10-Q, including, but not limited to: our quarterly operating results are volatile and difficult to predict, and if we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly; if demand for our products declines in our major end markets, our net revenues will decrease; intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products; if we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability; if we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies; and our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we have no obligation (and expressly disclaim any obligation) to update or alter any forward-looking statements, whether as a result of new information or otherwise except as otherwise required by securities regulations.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands)

	June 30, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$85,426	$63,394
Short-term marketable securities	59,630	31,766
Accounts receivable, net of allowances of $95 and $247 in 2013 and 2012, respectively (Note 2)	15,772	7,326
Inventories	43,199	44,625
Deferred tax assets	344	352
Prepaid expenses and other current assets	12,097	17,401
Total current assets	216,468	164,864
PROPERTY AND EQUIPMENT, net	89,743	89,724
INTANGIBLE ASSETS, net	44,054	47,738
GOODWILL	80,599	80,599
DEFERRED TAX ASSETS	14,425	11,532
OTHER ASSETS	4,608	4,673
Total assets	$449,897	$399,130
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$21,347	$16,452
Accrued payroll and related expenses	7,681	6,720
Taxes payable	1,476	1,213
Deferred tax liabilities	748	1,193
Deferred income on sales to distributors	15,035	11,550
Other accrued liabilities	2,650	3,439
Total current liabilities	48,937	40,567
LONG-TERM INCOME TAXES PAYABLE	8,665	7,937
DEFERRED TAX LIABILITIES	7,646	8,179
PENSION LIABILITY	1,366	1,398
Total liabilities	66,614	58,081
COMMITMENTS AND CONTINGENCIES (Notes 9, 11 and 12)		
STOCKHOLDERS' EQUITY:		
Common stock	29	28
Additional paid-in capital	198,375	175,668
Accumulated other comprehensive loss	(687)	(293)
Retained earnings	185,566	165,646
Total stockholders' equity	383,283	341,049
Total liabilities and stockholders' equity	$449,897	$399,130

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
NET REVENUES	$87,922	$76,382	$164,962	$148,155
COST OF REVENUES	41,715	38,627	78,891	75,807
GROSS PROFIT	46,207	37,755	86,071	72,348
OPERATING EXPENSES:				
Research and development	13,489	12,066	25,761	22,706
Sales and marketing	11,364	9,176	22,145	17,315
General and administrative	8,066	7,100	15,800	14,193
Total operating expenses	32,919	28,342	63,706	54,214
INCOME FROM OPERATIONS	13,288	9,413	22,365	18,134
OTHER INCOME				
Other income, net	565	195	782	810
Total other income	565	195	782	810
INCOME BEFORE PROVISION FOR (BENEFIT FROM) INCOME TAXES	13,853	9,608	23,147	18,944
PROVISION FOR (BENEFIT FROM) INCOME TAXES	181	16,784	(1,428)	18,659
NET INCOME (LOSS)	$13,672	$(7,176)	$24,575	$285
EARNINGS (LOSS) PER SHARE:				
Basic	$0.47	$(0.25)	$0.85	$0.01
Diluted	$0.45	$(0.25)	$0.82	$0.01
SHARES USED IN PER SHARE CALCULATION:				
Basic	29,178	28,619	28,967	28,423
Diluted	30,158	28,619	29,977	29,624

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income (loss)	$ 13,672	$ (7,176)	$ 24,575	$ 285
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments, net of $0 tax in the quarter and year to date ended June 30, 2013 and 2012 (Note 2)	(13)	(124)	(164)	(67)
Unrealized gain (loss) on marketable securities, net of $0 tax in the quarter and year to date ended June 30, 2013 and 2012 (Note 2)	(204)	(129)	(258)	162
Amortization of defined benefit pension items, net of tax of $4 and $8 in the quarter and year to date ended June 30, 2013 and $0 in both periods in 2012, respectively (Note 2)	14	—	28	—
Total other comprehensive income (loss)	(203)	(253)	(394)	95
Total comprehensive income (loss)	$ 13,469	$ (7,429)	$ 24,181	$ 380

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Six Months Ended June 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$24,575	$285
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	7,968	7,627
Amortization of intangibles	3,684	1,479
Loss (gain) on sale of property and equipment	17	(1)
Gain on sale of assets held for sale	(497)	—
Stock-based compensation expense	7,964	6,673
Amortization of premium on marketable securities	251	567
Non-cash interest income from SemiSouth note	—	(780)
Deferred income taxes	(2,388)	4,834
Reduction in accounts receivable allowances	(153)	(14)
Excess tax benefit from stock options exercised	—	(474)
Tax benefit associated with employee stock plans	—	1,531
Change in operating assets and liabilities:		
Accounts receivable	(8,294)	(5,336)
Inventories	1,421	14,119
Prepaid expenses and other assets	5,198	2,834
Accounts payable	3,457	3,795
Taxes payable and accrued liabilities	(480)	8,784
Deferred income on sales to distributors	3,484	3,387
Net cash provided by operating activities	46,207	49,310
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(6,892)	(8,754)
Proceeds from sale of property and equipment	36	2
Proceeds from sale of assets held for sale	959	—
Acquisition	—	(113,360)
Increase in financing lease receivable	—	(383)
Collections of financing lease receivable	—	299
Loan to SemiSouth	—	(18,000)
Purchases of marketable securities	(45,223)	—
Proceeds from maturities of marketable securities	16,850	12,468
Net cash used in investing activities	(34,270)	(127,728)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock under employee stock plans	14,749	14,321
Payments of dividends to stockholders	(4,654)	(2,853)
Excess tax benefit from stock options exercised	—	474
Net cash provided by financing activities	10,095	11,942

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	Six Months Ended June 30, 2013	2012
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	22,032	(66,476)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	63,394	139,836
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$85,426	$73,360
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unpaid property and equipment	$2,447	$1,578
Receipt of SemiSouth purchase option	$—	$6,216
Acquisition net asset value adjustment (Note 14)	$—	$2,358
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash (received) paid for income taxes, net of refunds	$(3,133)	$2,076

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:

The condensed consolidated financial statements include the accounts of Power Integrations, Inc., a Delaware corporation (the “Company”), and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2012, included in its Form 10-K filed on February 22, 2013, with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

No material changes have been made to the Company's significant accounting policies disclosed in Note 2, Summary of Significant Accounting Policies, in its Annual Report on Form 10-K, filed on February 22, 2013, for the year ended December 31, 2012. The accounting policy information below is to aid in the understanding of the financial information disclosed.

Cash and Cash Equivalents

The Company considers cash invested in highly liquid financial instruments with maturities of three months or less at the date of purchase to be cash equivalents.

Marketable Securities

The Company generally holds securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments. As a result the Company classifies its investment portfolio as available-for-sale. The Company classifies all investments with an original maturity date greater than three months as short-term investments in its Condensed Consolidated Balance Sheet. The Company's short-term investment portfolio is invested in highly liquid financial instruments with maturities greater than three months. As of June 30, 2013, and December 31, 2012, the Company's marketable securities consisted primarily of corporate securities, commercial paper and other high-quality commercial securities.

Amortized cost and estimated fair market value of investments classified as available-for-sale at June 30, 2013, are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	$15,891	$—	$—	$15,891
Corporate securities	8,605	6	—	8,611
Total	$24,496	$6	$—	$24,502

Investments due in 4-12 months:				
Corporate securities	$7	$—	$—	$7
Total	$7	$—	$—	$7
Investments due in more than 12 months:				
Corporate securities	$51,138	$57	$(183)	$51,012
Total	$51,138	$57	$(183)	$51,012
Total investment securities	$75,641	$63	$(183)	$75,521

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Amortized cost and estimated fair market value of investments classified as available-for-sale at December 31, 2012, are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Corporate securities	$1,500	$1	$—	$1,501
Total	$1,500	$1	$—	$1,501
Investments due in 4-12 months:				
Corporate securities	$24,127	$83	$—	$24,210
Total	$24,127	$83	$—	$24,210
Investments due in more than 12 months:				
Corporate securities	$6,000	$55	$—	$6,055
Total	$6,000	$55	$—	$6,055
Total investment securities	$31,627	$139	$—	$31,766

As of June 30, 2013, the Company evaluated the nature of the investments with a loss position which were primarily high-quality corporate securities, and determined the unrealized losses were not other-than-temporary. At December 31, 2012, the Company had no marketable securities in an unrealized loss position.

Revenue Recognition

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Approximately 75% of the Company's net product sales were made to distributors in the six months ended June 30, 2013, and 74% in the twelve months ended December 31, 2012. The Company applies the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the Company's customer. The Company evaluates whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to collectability, the Company performs credit checks for new customers and performs ongoing evaluations of its existing customers' financial condition and requires letters of credit whenever deemed necessary.

Sales to international OEM customers and merchant power supply manufacturers that are shipped from the Company's facility in California are pursuant to “delivered at frontier” (“DAF”) shipping terms. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of the product in that country. Sales to international OEMs and merchant power supply manufacturers for shipments from the Company's facility outside of the United States are pursuant to “EX Works” ("EXW") shipping terms, meaning that title to the product transfers to the customer upon shipment from the Company's foreign warehouse. Shipments to OEMs and merchant power supply manufacturers in the Americas are pursuant to “free on board” (“FOB”) point of origin shipping terms meaning that title is passed to the customer upon shipment. Revenue is recognized upon title transfer for sales to OEMs and merchant power supply manufacturers, assuming all other criteria for revenue recognition are met.

Sales to most of the Company's distributors are made under terms allowing certain price adjustments and rights of return on the Company's products held by its distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until the Company's distributors report that they have sold the Company's products to their customers. The Company's recognition of such distributor revenue is based on point of sale reports received from the distributors, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to the Company except pursuant to warranty terms. The gross profit that is deferred as a result of this policy is reflected as “deferred income on sales to distributors” in the accompanying condensed consolidated balance sheets. The total deferred revenue as of June 30, 2013, and December 31, 2012, was approximately $25.7 million and $20.7 million, respectively. The total deferred cost as of June 30, 2013, and December 31, 2012, was approximately $10.7 million and $9.1 million, respectively.

Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At or soon after the distributor invoices its customer, the distributor submits a “ship and debit” price adjustment claim to the Company to adjust the distributor's cost from the standard price to the pre-approved lower price. After verification by the Company, a credit memo is issued to the distributor for the ship and debit claim. The Company maintains a reserve for unprocessed claims and future ship and debit price adjustments. The reserve appears as a reduction to accounts receivable in the Company's accompanying consolidated balance sheets. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on the deferred revenue and deferred margin ultimately recognized. To evaluate the adequacy of its reserves, the Company analyzes historical ship and debit payments and levels of inventory in the distributor channels.

Sales to certain distributors of the Company are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, product revenue is recognized upon shipment and title transfer assuming all other revenue recognition criteria are met.

Common Stock Repurchases and Cash Dividend

In October 2012, the Company's board of directors authorized the use of $50 million for the repurchase of the Company's common stock, repurchases are to be executed according to pre-defined price/volume guidelines set by the board of directors. In the first half of 2013, the Company did not purchase any common stock under the program due to the then current stock price levels. As of June 30, 2013, the Company had $29.5 million available for future stock repurchases. Authorization of future stock repurchase programs is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions as well as other factors.

In January 2012, the Company's board of directors declared four quarterly cash dividends in the amount of $0.05 per share to be paid to stockholders of record at the end of each quarter in 2012. Each quarterly dividend payment was approximately $1.4 million and was paid on March 30, 2012, on June 29, 2012, September 28, 2012, and December 31, 2012. In January 2013, the Company's board of directors continued the dividend payments by declaring four quarterly cash dividends in the amount of $0.08 per share to be paid to stockholders of record at the end of each quarter in 2013. The first quarterly dividend of approximately $2.3 million was paid on March 29, 2013, and the second quarterly dividend payment of $2.3 million was paid on June 28, 2013. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the Company's stockholders.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition, income tax, stock-based compensation and inventories. These estimates are based on historical facts and various other assumptions that the Company believes to be reasonable at the time the estimates are made.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Components of the Company's Condensed Consolidated Balance Sheet
Accounts Receivable (in thousands):

	June 30, 2013	December 31, 2012
Accounts receivable trade	$42,733	$33,866
Accrued ship and debit and rebate claims	(26,866)	(26,293)
Allowance for doubtful accounts	(95)	(247)
Total	$15,772	$7,326

Prepaid Expenses and Other Current Assets (in thousands):

	June 30, 2013	December 31, 2012
Prepaid legal fees	$1,104	$1,760
Prepaid income tax	7,348	11,463
Prepaid maintenance agreements	347	616
Interest receivable	312	149
Supplier prepayment	606	1,170
Other	2,380	2,243
Total	$12,097	$17,401

Changes in accumulated other comprehensive income (loss) for the three months ended June 30, 2013 (in thousands):

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Foreign Currency Items	Total
Beginning balance at April 1, 2013	$84	$(546)	$(22)	$(484)
Other comprehensive income before reclassifications	(204)	—	(13)	(217)
Amounts reclassified from accumulated other comprehensive income	—	14 (1)	—	14
Net-current period other comprehensive income	(204)	14	(13)	(203)
Ending balance at June 30, 2013	$(120)	$(532)	$(35)	$(687)

(1) This component of accumulated other comprehensive income is included in the computation of net periodic pension cost for the three months ended June 30, 2013.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in accumulated other comprehensive income (loss) for the six months ended June 30, 2013 (in thousands):

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Foreign Currency Items	Total
Beginning balance at December 31, 2012	$138	$(560)	$129	$(293)
Other comprehensive income before reclassifications	(258)	—	(164)	(422)
Amounts reclassified from accumulated other comprehensive income	—	28 (1)	—	28
Net-current period other comprehensive income	(258)	28	(164)	(394)
Ending balance at June 30, 2013	$(120)	$(532)	$(35)	$(687)

(1) This component of accumulated other comprehensive income is included in the computation of net periodic pension cost for the six months ended June 30, 2013.

3. STOCK PLANS AND SHARE-BASED COMPENSATION:

Stock Plans
As of June 30, 2013, the Company had two stock-based compensation plans (the “Plans”) which are described below.

2007 Equity Incentive Plan

The 2007 Equity Incentive Plan (the "2007 Plan") was adopted by the board of directors on September 10, 2007 and approved by the stockholders on November 7, 2007, as an amendment and restatement of the 1997 Stock Option Plan (the "1997 Plan"). The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards ("RSUs"), stock appreciation rights, performance-based awards ("PSUs") and other stock awards to employees, directors and consultants. As of June 30, 2013, the maximum remaining number of shares that may be issued under the 2007 Plan was 7,706,590 shares, which includes options granted but not exercised and awards granted but unvested and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options and stock awards under the 1997 Plan. Pursuant to the 2007 Plan, the exercise price for incentive stock options and nonstatutory stock options is generally at least 100% of the fair market value of the underlying shares on the date of grant. Options generally vest over 48 months measured from the date of grant. Options generally expire no later than ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

Beginning January 27, 2009, grants pursuant to the Directors Equity Compensation Program (that was adopted by the board of directors on January 27, 2009) to nonemployee directors have been made primarily under the 2007 Plan. The Directors Equity Compensation Program, until June 2012, provided in certain circumstances (depending on the status of the particular director's holdings of Company stock options) for the automatic annual grant of nonstatutory stock options to nonemployee directors of the Company on the first trading day of July in each year over their period of service on the board of directors. Further, each future nonemployee director of the Company would be granted the following initial grants under the 2007 Plan: (a) on the first trading day of the month following commencement of service, an option to purchase the number of shares of common stock equal to: the fraction of a year between the date of the director's appointment to the board of directors and the next July 1, multiplied by 8,000, which option shall vest on the next July 1st; and (b) on the first trading day of July following commencement of service, an option to purchase 24,000 shares vesting monthly over the three year period commencing on the grant date. In July 2012, this program was amended by eliminating the grants described above in their entirety, and providing for grants to outside directors as follows: effective annually, upon the first trading day of July, each outside director would receive a grant of an equity award with an aggregate value of $100,000, which will become exercisable or vest immediately prior to the Company's next year Annual Meeting of Stockholders, subject to the directors continued service. At each outside directors election, such award would consist entirely of RSUs or entirely of stock options. The quantity of options would be calculated by dividing $100,000 by the Black-Scholes value on the date of grant. The quantity of RSUs issued would be calculated by dividing $100,000 by the grant date fair value. Further, on the date of election of a new outside director, such

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

new director would receive such grant as continuing outside directors receive on the first trading day of July; provided, however, that such grant is prorated for the portion of the year that such new outside director will serve until the next first trading day of July. The Directors Equity Compensation Program will remain in effect at the discretion of the board of directors or the compensation committee.

On July 28, 2009, the 2007 Plan was amended generally to prohibit outstanding options or stock appreciation rights from being cancelled in exchange for cash without stockholder approval.

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the “Purchase Plan”), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee's compensation, to the purchase of shares of the Company's common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company's common stock on the first day of each offering period, or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock were reserved for issuance to employees under the Purchase Plan. As of June 30, 2013, 2,541,673 shares had been purchased and 458,327 shares were reserved for future issuance under the Purchase Plan.

Stock-Based Compensation

The Company applies the provisions of ASC 718-10. Under the provisions of ASC 718-10, the Company recognizes the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. The Company uses estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation expense to recognize. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award.

Determining Fair Value of Stock Options

The Company uses the Black-Scholes valuation model for valuing stock option grants using the following assumptions and estimates:

Expected Volatility. The Company calculates expected volatility based on the historical price volatility of the Company's stock.

Expected Term. The Company utilizes a model which uses historical exercise, cancellation and outstanding option data to calculate the expected term of stock option grants.

Risk-Free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes valuation model on the implied yield available on a U.S. Treasury note with a term approximately equal to the expected term of the underlying grants.

Dividend Yield. The dividend yield was calculated by dividing the annual dividend by the average closing price of the Company's common stock on a quarterly basis.

Estimated Forfeitures. The Company uses historical data to estimate pre-vesting forfeitures, and records share-based compensation expense only for those awards that are expected to vest.

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three and six months ended June 30, 2013, and June 30, 2012 (in thousands).

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Cost of revenues	$264	$256	$528	$501
Research and development	1,640	1,566	2,746	2,687
Sales and marketing	795	746	1,624	1,493
General and administrative	1,629	1,074	3,066	1,992
Total stock-based compensation expense	$4,328	$3,642	$7,964	$6,673

Stock compensation expense in the three months ended June 30, 2013, was $4.3 million (comprising approximately $0.7 million related to stock options, $0.9 million related to performance-based awards, $2.4 million related to restricted stock units and $0.3 million related to the Purchase Plan). In the six months ended June 30, 2013, stock compensation expense was $8.0 million (comprising approximately $1.7 million related to stock options, $1.3 million related to performance shares, $4.4 million related to restricted stock units and $0.6 million related to the Purchase Plan).

Stock compensation expense in the three months ended June 30, 2012, was $3.6 million (comprising approximately $0.9 million related to stock options, $0.7 million related to performance-based awards, $1.7 million related to restricted stock units and $0.3 million related to the Purchase Plan). In the six months ended June 30, 2012, stock compensation expense was $6.7 million (comprising approximately $1.9 million related to stock options, $1.1 million related to performance shares, $3.1 million related to restricted stock units and $0.6 million related to the Purchase Plan).

The following table summarizes total compensation expense related to unvested awards not yet recognized, net of expected forfeitures, and the weighted-average period over which it is expected to be recognized as of June 30, 2013.

	June 30, 2013	
	Unrecognized Compensation Expense for Unvested Awards (In thousands)	Weighted Average Remaining Recognition Period (In years)
Options	$2,569	1.88
Performance-based awards	2,013	0.50
Restricted stock units	22,927	2.95
Purchase plan	96	0.50
Total unrecognized compensation expense	$27,605	

The fair value of stock options granted is established on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	*2013	2012	*2013	2012
Risk-free interest rates	— %	1.01 %	— %	1.01 %
Expected volatility rates	— %	45 %	— %	45 %
Expected dividend yield	— %	0.51 %	— %	0.51 %
Expected term of stock options (in years)	0	6.4	0	6.4
	$—	$18.31	$—	$18.31

Weighted-average grant date fair value of options granted

*The Company did not grant stock options in the first six months of 2013, and therefore no fair-value assumptions were reported for those periods.

The fair value of employees' stock purchase rights under the Purchase Plan was estimated using the Black-Scholes model with the following weighted-average assumptions:

	*Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Risk-free interest rates	—%	—%	0.11%	0.09%
Expected volatility rates	—%	—%	33%	48%
Expected dividend yield	—%	—%	0.80%	0.54%
Expected term of purchase right (in years)	0	0	0.5	0.5
Weighted-average estimated fair value of purchase rights	$—	$—	$9.14	$10.42

*There were no employee stock purchase rights granted in the three months ended June 30, 2013 and 2012.

A summary of stock option activity under the Plans, excluding performance-based awards and restricted stock units, as of June 30, 2013, and changes during the six months then ended is presented below:

	Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2013	2,817	$26.00		
Granted	—	—		
Exercised	(531)	$23.94		
Forfeited or expired	(19)	$39.70		
Outstanding at June 30, 2013	2,267	$26.37	4.3	$32,457
Exercisable at June 30, 2013	2,052	$25.00	3.9	$32,007
Vested and expected to vest at June 30, 2013	2,259	$26.32	4.3	$32,449

The Company did not grant stock options in the six months ended June 30, 2013. Since 2010 the Company's equity grants to new hires and its annual incentive grants to non-executive employees have been primarily in the form of RSUs. The total intrinsic value of options exercised during the three and six months ended June 30, 2013, was $5.0 million and $10.1 million, respectively. The intrinsic value of options exercised during the three and six months ended June 30, 2012, was $7.6 million and $11.5 million, respectively.

Performance-based Awards

Under the performance-based awards program, the Company grants awards in the first half of the performance year in an amount equal to twice the target number of shares to be issued if the target performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the targeted number depending on the Company's performance. The performance metrics of this program are annual targets consisting of net revenue, non-GAAP operating earnings and strategic goals. Each performance-based award granted from the 2007 Plan will reduce the number of shares available for issuance under the 2007 Plan by 2.0 shares.

During the six months ended June 30, 2013, the Company issued approximately 101,000 performance-based awards to employees and executives. As the net revenue, non-GAAP operating earnings and achievement of strategic goals are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, are recorded throughout the year depending on the number of shares expected to be earned based on progress toward the performance targets. The cost of performance-based awards is determined using the fair value of the Company's common stock on the grant date, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

In January 2013, it was determined that approximately 54,000 shares of the approximately 102,000 performance-based awards granted in 2012 vested in aggregate under the revenue, non-GAAP operating income and strategic goals performance conditions for such awards. Accordingly, 54,000 performance-based awards were released to the Company's employees and executives in the first quarter of 2013.

A summary of performance-based awards outstanding as of June 30, 2013, and activity during the six months then ended, is presented below:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2013	102	$37.60		
Granted	101	$38.62		
Vested	(54)	$37.60		
Change in units due to performance achievement for PSUs vested in the year	(48)	$37.60		
Forfeited or expired	(2)	$41.79		
Outstanding at June 30, 2013	99	$38.50	0.50	$4,024
Outstanding and expected to vest at June 30, 2013	87		0.50	$3,520

The weighted-average grant-date fair value per share of performance-based awards granted in the three and six months ended June 30, 2013, was approximately $41.78 and $38.62, respectively, and $42.68 and $37.60 respectively, in the same periods of 2012. There were no awards released in the three months ended June 30, 2013, and the grant date fair value of awards released, which were fully vested, in the six months ended June 30, 2013, was approximately $2.0 million. There were no performance-based awards released in the three or six months ended June 30, 2012, as the performance-based awards granted in 2011 were canceled without vesting.

Restricted Stock Units (RSUs)

The Company grants restricted stock units to employees under the 2007 Plan. RSUs granted to employees typically vest ratably over a four-year period, and are converted into shares of the Company's common stock upon vesting on a one-for-one basis subject to the employee's continued service to the Company over that period. The fair value of RSUs is determined using the fair value of the Company's common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. Compensation expense is recognized on a straight-line basis over the requisite service period of each grant adjusted for estimated forfeitures. Each RSU award granted from the 2007 plan will reduce the number of shares available for issuance under the 2007 Plan by 2.0 shares. A summary of RSUs outstanding as of June 30, 2013, and changes during the six months then ended, is as follows:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2013	573	$38.21		
Granted	353	$38.28		

Vested	(176)	$38.44		
Forfeited or expired	(35)	$39.17		
Outstanding at June 30, 2013	715	$38.43	1.85	$29,017
Outstanding and expected to vest at June 30, 2013	656		1.82	$26,595

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The weighted-average grant-date fair value per share of RSUs awarded in the three and six months ended June 30, 2013, was approximately $40.80 and $38.28, respectively. The weighted-average grant-date fair value per share of RSUs awarded in the three and six months ended June 30, 2012, was approximately $41.97 and $41.88, respectively. The grant date fair value of RSUs vested in the three and six months ended June 30, 2013, was approximately $6.5 million and $6.8 million, respectively, and the grant date fair value of RSUs vested in the three and six months ended June 30, 2012, was approximately $3.7 million and $3.8 million, respectively.

4. FAIR VALUE MEASUREMENTS:

ASC 820-10, Fair Value Measurements, clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820-10 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices for identical assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's cash and investment instruments are classified within Level 1 or Level 2 of the fair-value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The type of instrument valued based on quoted market prices in active markets primarily includes money market securities. This type of instrument is generally classified within Level 1 of the fair-value hierarchy. The types of instruments valued based on other observable inputs (Level 2 of the fair-value hierarchy) include investment-grade corporate bonds and government, state, municipal and provincial obligations. Such types of investments are valued by using a multi-dimensional relational model, the inputs are primarily benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data including market research publications. In the first quarter of 2012, the Company changed its investment policy to allow the sale of long-term and short-term marketable securities prior to their stated maturity date. The Company principally holds securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, the funding of acquisitions and other strategic investments. As a result of this change in policy the Company classified its investment portfolio as available-for-sale. The Company's investments classified as Level 1 and Level 2 are available-for-sale investments, and were recorded at fair market value.

The fair value hierarchy of the Company's marketable securities at June 30, 2013, and December 31, 2012, was as follows (in thousands):

	Fair Value Measurement at June 30, 2013		
Description	June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	$22,201	$22,201	$—
Commercial paper	15,891	—	15,891
Corporate securities	59,630	—	59,630
Total	$97,722	$22,201	$75,521

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	Fair Value Measurement at December 31, 2012		
Description	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	$7,140	$7,140	$—
Corporate securities	31,766	—	31,766
Total	$38,906	$7,140	$31,766

The Company did not transfer any investments between Level 1 and Level 2 of the fair-value hierarchy in the six months ended June 30, 2013, and the twelve months ended December 31, 2012.

5. INVENTORIES:

Inventories (which consist of costs associated with the purchases of wafers from domestic and offshore foundries and of packaged components from offshore assembly manufacturers, as well as internal labor and overhead associated with the testing of both wafers and packaged components) are stated at the lower of cost (first-in, first-out) or market. Provisions, when required, are made to reduce excess and obsolete inventories to their estimated net realizable values. Inventories consist of the following (in thousands):

	June 30, 2013	December 31, 2012
Raw materials	$10,427	$10,564
Work-in-process	13,885	12,122
Finished goods	18,887	21,939
Total	$43,199	$44,625

6. GOODWILL AND INTANGIBLE ASSETS:

There were no changes in the carrying amount of goodwill during the six months ended June 30, 2013.

Intangible assets consist primarily of developed technology, acquired licenses, customer relationships, trade name, in-process research and development and patent rights, and are reported net of accumulated amortization. The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the developed technology, acquired licenses, customer relationships, trade name and patent rights, which range from 2 to 12 years, with the exception of $4.7 million of in-process research and development. In-process research and development is assessed for impairment until the development is completed and products are available for sale, at which time the Company will begin to amortize the in-process research and development. The Company does not expect the amortization to begin in 2013. Amortization for acquired intangible assets was approximately $1.8 million and $3.7 million in the three and six months ended June 30, 2013, respectively, and $1.3 million and $1.5 million in the three and six months ended June 30, 2012, respectively. The Company does not believe there is any significant residual value associated with the following intangible assets:

	June 30, 2013			December 31, 2012		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(in thousands)					
In-process research and development	$4,690	$—	$4,690	$4,690	$—	$4,690
Technology licenses	3,000	(2,175)	825	3,000	(2,025)	975
Patent rights	1,949	(1,949)	—	1,949	(1,949)	—
Developed technology	26,670	(3,955)	22,715	26,670	(2,663)	24,007
Customer relationships	17,610	(3,286)	14,324	17,610	(1,944)	15,666
Tradename	3,600	(2,100)	1,500	3,600	(1,200)	2,400
Other intangibles	37	(37)	—	37	(37)	—
Total intangible assets	$57,556	$(13,502)	$44,054	$57,556	$(9,818)	$47,738

The estimated future amortization expense related to intangible assets at June 30, 2013, is as follows:

Fiscal Year	Estimated Amortization
	(in thousands)
2013 (remaining 6 months)	$3,721
2014	6,072
2015	5,009
2016	4,394
2017	3,994
Thereafter	16,174
Total (1)	$39,364

(1) The total above excludes $4.7 million of in-process research and development that will be amortized upon completion of development over the estimated useful life of the technology.

7. SIGNIFICANT CUSTOMERS AND EXPORT SALES:

Segment Reporting

The Company is organized and operates as one reportable segment, the design, development, manufacture and marketing of integrated circuits and related components for use primarily in the high-voltage power-conversion market. The Company's chief operating decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance.

Customer Concentration

Ten customers accounted for approximately 60% and 59% of net revenues for the three and six months ended June 30, 2013, respectively and 64% and 65% for the same periods of 2012, respectively. A significant portion of these revenues are attributable to sales of the Company’s products to distributors of electronic components. These distributors sell the Company’s products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers.

The following customers accounted for 10% or more of total net revenues:

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	Three Months Ended June 30,				Six Months Ended June 30,			
Customer	2013		2012		2013		2012	
A	19	%	21	%	19	%	21	%
B	*		12	%	*		12	%

* Total customer revenue was less than 10% of net revenues.

Customers A and B are distributors of the Company's products. No other customers accounted for 10% or more of the Company's net revenues in those periods.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company has cash investment policies that limit cash investments to low-risk investments. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit exposure related to its customers. As of June 30, 2013, and December 31, 2012, 72% and 74%, respectively, of accounts receivable were concentrated with the Company's top 10 customers.
The following customers represented 10% or more of accounts receivable:

Customer	June 30, 2013		December 31, 2012	
A	33	%	28	%
B	12	%	18	%

Customers A and B are distributors of the Company’s products. No other customers accounted for 10% or more of the Company’s accounts receivable in these periods.

International Sales

The Company markets its products in and outside of North and South America through its sales personnel and a worldwide network of independent sales representatives and distributors. As a percentage of total net revenues, international sales, which consist of domestic and foreign sales to distributors and direct customers outside of the Americas, comprise the following:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2013		2012		2013		2012	
Hong Kong/China	48	%	44	%	46	%	44	%
Taiwan	15	%	17	%	15	%	17	%
Korea	10	%	12	%	12	%	13	%
Western Europe (excluding Germany)	10	%	10	%	11	%	10	%
Japan	6	%	6	%	5	%	6	%
Singapore	2	%	2	%	2	%	2	%
Germany	2	%	1	%	2	%	1	%

Other	1	%	2	%	1	%	2	%
Total foreign revenue	94	%	94	%	94	%	95	%

The remainder of the Company's sales are to customers within the Americas, primarily located in the United States.

Product Sales

Revenue mix by end market for the three and six months ended June 30, 2013 and 2012, was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
End Market	2013	2012	2013	2012
Consumer	34 %	36 %	35 %	38 %
Communications	21 %	24 %	21 %	25 %
Industrial	35 %	28 %	34 %	25 %
Computer	10 %	12 %	10 %	12 %

8. EARNINGS PER SHARE:

Basic earnings per share are calculated by dividing net income by the weighted-average shares of common stock outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted-average shares of common stock and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares included in this calculation consist of dilutive shares issuable upon the assumed exercise of outstanding common stock options, the assumed vesting of outstanding restricted stock units and performance based awards, and the assumed issuance of awards under the stock purchase plan, as computed using the treasury stock method. Basic and diluted loss per share is calculated by dividing the net loss by the weighted-average shares of common stock outstanding during the period.

A summary of the earnings (loss) per share calculation is as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Basic earnings per share:				
Net income (loss)	$13,672	$(7,176)	$24,575	$285
Weighted-average common shares	29,178	28,619	28,967	28,423
Basic earnings (loss) per share	$0.47	$(0.25)	$0.85	$0.01
Diluted earnings per share (1):				
Net income (loss)	$13,672	$(7,176)	$24,575	$285
Weighted-average common shares	29,178	28,619	28,967	28,423
Effect of dilutive securities:				
Employee stock plans	980	—	1,010	1,201
Diluted weighted-average common shares	30,158	28,619	29,977	29,624
Diluted earnings (loss) per share	$0.45	$(0.25)	$0.82	$0.01

(1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share if the performance conditions have been satisfied as of the end of the reporting period and excludes such shares when the necessary conditions have not been met. The Company has excluded the shares underlying the 2013 and 2012 awards in the 2013 and 2012 calculation, respectively, as those shares were not contingently

issuable as of the end of the period.

In the three and six months ended June 30, 2013, 167,862 shares and 166,042 shares, respectively, and in the six months ended June 30, 2012, 306,586 shares were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive. In the three months ended June 30, 2012, all shares attributable to stock-based awards were excluded in the computation of diluted earnings per share, as the Company was in a net loss position.

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9. PROVISION FOR INCOME TAXES:

The Company accounts for income taxes under the provisions of ASC 740. Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income. In the event that the Company determines, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, the Company would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on its results of operations and financial position.

As of June 30, 2013, the Company continues to maintain a valuation allowance on capital losses for federal purposes (see Note 15, Transactions with Third Party, for details on SemiSouth), and on its California deferred tax assets as the Company believes that it is not more likely than not that these deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating to tax credits in Canada.

Income tax expense includes a provision for (benefit from) federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur. The Company's effective tax rates for the three and six months ended June 30, 2013, were 1.3% and (6.2)%, respectively. The difference between the expected statutory rate of 35% and the Company's effective tax rate for the three and six months ended June 30, 2013, was primarily due to the beneficial impact of the geographic distribution of the Company's world-wide earnings and passage of the American Tax Relief Act of 2012 signed into law on January 2, 2013. The prior year impact of the 2012 Federal research and development tax credit benefit was recorded in the quarter ended March 31, 2013. The difference between the expected statutory rate of 35% and the Company's effective tax rate for the three and six months ended June 30, 2012, was primarily due to a provision for income tax in the second quarter of 2012 which included a one-time charge of $44.8 million, in connection with settling the U.S. Internal Revenue Service ("IRS") examination of the Company's income tax returns in August 2012, for the years 2003 through 2006. The settlement included: $35.0 million in federal income taxes, net interest of $5.7 million and state income taxes (including interest) of approximately $4.1 million. The impact of the charge was partially offset by the reversal of $26.9 million of related unrecognized tax benefits that had been recorded as non-current liabilities in the Company's consolidated balance sheets, resulting in a net charge of $18.1 million. Additionally, there was a $2.2 million reduction of the valuation allowance on the Company's California deferred tax assets. Reflecting the net impact of the charge, the Company's effective tax rates for the three- and six-month periods ended June 30, 2012 were 174.7% and 98.5%, respectively. The fiscal years 2007 through 2009 are currently under audit by the IRS.

The tax settlement confirmed that the royalty arrangement between the Company and its foreign subsidiary concluded on October 31, 2012, resulting in a substantially lower effective tax rate for the Company in future years. As a result of the royalty arrangement ending and to ensure an additional source of U.S. cash, the Company plans to repatriate a portion of its current year offshore earnings to the U.S. for domestic operations and accordingly has provided for estimated federal and state income taxes on such earnings. For earnings accumulated as of December 31, 2012, and for the remaining portion of the current year earnings, the Company continues to permanently reinvest such amounts in its foreign jurisdictions, except to the extent there is any previously taxed income which is expected to be repatriated. If circumstances change and it becomes apparent that some or all of those undistributed earnings of the Company's offshore subsidiary will be remitted in the foreseeable future but income taxes have not been recognized, the Company will accrue income taxes attributable to that remittance.

Determining the consolidated provision for (benefit from) income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

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10. INDEMNIFICATIONS:

The Company sells products to its distributors under contracts, collectively referred to as Distributor Sales Agreements (“DSA”). Each DSA contains the relevant terms of the contractual arrangement with the distributor, and generally includes certain provisions for indemnifying the distributor against losses, expenses, and liabilities from damages that may be awarded against the distributor in the event the Company's products are found to infringe upon a patent, copyright, trademark, or other proprietary right of a third party (“Customer Indemnification”). The DSA generally limits the scope of and remedies for the Customer Indemnification obligations in a variety of industry-standard respects, including, but not limited to, limitations based on time and geography, and a right to replace an infringing product. The Company also, from time to time, has granted a specific indemnification right to individual customers.

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of June 30, 2013. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

11. COMMITMENTS:

Supplier Agreements

Three of the Company's major suppliers have wafer supply agreements based in U.S. dollars; however, the agreements with two of these foundries, Seiko Epson Corporation, or Epson, and ROHM Lapis Semiconductor Co., Ltd., or Lapis, also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, the Company's management and these two suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between the Company and each of these suppliers.

12. LEGAL PROCEEDINGS AND CONTINGENCIES:

From time to time in the ordinary course of business, the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. In accordance with ASC 450-10, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integrations patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $34.0 million in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages award. Fairchild also raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys' fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to $6.1 million, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys' fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent injunction for 90 days to permit Fairchild to petition the Federal Circuit Court of Appeals for a further stay. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December 2008. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement, and the parties completed post-trial briefing on the issue of willfulness shortly thereafter. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents. The Court also invited briefing on enhanced damages and attorneys' fees, and Fairchild filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of $12.9 million. Fairchild filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company filed a cross-appeal seeking to increase the damages award. The appeal was argued on January 11, 2012, and the Federal Circuit issued a mixed ruling on March 26, 2013, affirming Fairchild's infringement of certain claims that support the basis for the permanent injunction while reversing, vacating, and remanding the findings with respect to other claims, including the Company's claim for damages. The Company intends to pursue its claim for financial compensation based on Fairchild's infringement, but no further schedule has been set for such proceedings at this time.

On May 9, 2005, the Company filed a Complaint with the U.S. International Trade Commission (“ITC”) under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337 against System General (“SG”). The Company filed a supplement to the complaint on May 24, 2005. The Company alleged infringement of its patents pertaining to pulse width modulation (“PWM”) integrated circuit devices produced by SG, which are used in power conversion applications such as power supplies for computer monitors. The Commission instituted an investigation on June 8, 2005 in response to the Company's complaint. SG filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. The Company subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (“ALJ”) from January 18 to January 24, 2006. Post-hearing briefs were submitted and briefing concluded February 24, 2006. The ALJ's initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. After further briefing, on June 30, 2006, the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing SG PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing SG chip. The U.S. Customs Service is authorized to enforce the exclusion order. On October 11, 2006, the presidential review period expired without any action from the President, and the ITC exclusion order is now in full effect. SG appealed the ITC decision, and on November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects. On October 27, 2008, SG filed a petition to modify the exclusion order in view of a recent Federal Circuit opinion in an unrelated case, and the Company responded to oppose any modification, but the Commission modified the exclusion order on February 27, 2009. Nevertheless, the exclusion order still prohibits SG and related entities from importing the infringing SG chips and any LCD computer monitors, AC printer adapters, and sample/demonstration circuit boards containing an infringing SG chip.

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly-owned subsidiary System General Corporation in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On February 10, 2011, the Court issued an order maintaining the stay with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case pending the appeal in that case. On April 18, 2011, the Court rescheduled the trial to begin in January 2012, and on June 2, 2011, the Court moved the trial date to permit the parties to address another patent the Company has accused Fairchild of infringing. Following a trial in April 2012, the jury returned a verdict finding that Fairchild infringes two of the Company's patents, that Fairchild has induced others to infringe the Company's patents, and also upheld the validity of the infringed patents. Of the two remaining counterclaim patents Fairchild asserted in the case, one was found not to be infringed, but the jury found the second patent to be infringed by a limited number of the Company's products, although the jury further found the Company did not induce infringement by any customers, including customers outside the United States. On March 29, 2013, the District Court denied most of the parties' post-trial motions on liability but granted the Company's motion for judgment as a matter of law finding that Fairchild infringed another of the Company's patents. On April 25, 2013, the Court denied both parties' motions regarding the enforceability of each other's patents. The Company intends to challenge adverse findings on appeal; nevertheless, the Company estimates that even if the infringement verdict on Fairchild's patent were ultimately upheld, the sales potentially impacted would amount to only about 0.3% of the Company's revenues. No schedule has been set for further proceedings, but the Company will also seek an injunction preventing further infringement of its own patents and is seeking financial damages, as well as enhanced damages for willful infringement, issues to be decided in separate proceedings at a later date.

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against SG Corporation, a Taiwanese company, and its U.S. subsidiary. The Company's complaint alleged that certain integrated circuits produced by SG infringed and continue to infringe certain of its patents. On June 10, 2005, in response to the initiation of the International Trade Commission (ITC) investigation discussed above, the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay and scheduled a case management conference. On December 6, 2006, SG filed a notice of appeal of the ITC decision as discussed above. In response, and by agreement of the parties, the District Court vacated the scheduled case management conference and renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination. On November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects, and SG did not file a petition for review. The parties subsequently filed a motion to dismiss the District Court case without prejudice. On November 4, 2009, the Company re-filed its complaint for patent infringement against SG and its parent corporations, Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation, to address their continued infringement of patents at issue in the original suit that recently emerged from SG requested reexamination proceedings before the U.S. Patent and Trademark Office (USPTO). The Company seeks, among other things, an order enjoining Fairchild and SG from infringing the Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that one of the two patents now at issue in the case is unenforceable. On May 5, 2010, Fairchild and SG filed an amended answer including counterclaims accusing the Company of infringing two patents; the Company contests these new claims vigorously, and since that time Fairchild has withdrawn its claim for infringement of one of the patents it asserted against the Company, leaving just one Fairchild patent in the case. The Court held a claim construction hearing on March 24, 2011, and has issued several claim construction orders; discovery is currently under way. Fairchild recently added another patent to the case over the Company's objections, and trial is scheduled for February of 2014.

In February 2010, Fairchild and System General (“SG”) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The suits assert four Chinese patents and seek an injunction and damages of approximately $19.0 million. Power Integrations Netherlands filed invalidation proceedings for all four asserted SG patents in the People's Republic of China Patent Reexamination Board (PRB) of the State Intellectual Property Office (SIPO), and all four challenges were accepted by the PRB, with hearings conducted in September 2010. In early January 2012, the Company received rulings from the PRB invalidating the majority of the claims Fairchild asserted in litigation, and the PRB determinations are currently on appeal. The Suzhou Court conducted evidentiary hearings in 2012 and issued rulings in late December 2012, finding that the Company did not infringe any of Fairchild's patents. Fairchild has filed appeals challenging the Suzhou Court's non-infringement rulings, but the Company continues to believe the Fairchild and SG claims discussed above are without merit and will continue to contest them vigorously.

On July 11, 2011, the Company filed a complaint in the U.S. District Court, District of Columbia, against David Kappos in his capacity as Director of the United States Patent and Trademark Office (“PTO”) as part of the ongoing reexamination proceedings related to one of the patents asserted against Fairchild and SG in the Delaware litigation described above. The Company filed a motion for summary judgment on a preliminary jurisdictional issue, and the PTO filed a cross-motion to dismiss on this same issue; briefing on these motions is now complete, with a ruling expected in the coming months. No schedule has been set for the case.

On May 1, 2012, Fairchild Semiconductor Corporation and Fairchild's wholly-owned subsidiary, System General Corporation (referred to collectively as “Fairchild”), filed a complaint against the Company in the United States District Court for the District of Delaware. In its complaint, Fairchild alleges that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company has answered Fairchild's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid, and the Company has also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild has withdrawn its claim for infringement of one of the patents it asserted against the Company after the Company's preliminary challenge; discovery is under way on the remaining patents, with a trial scheduled for October 2014.

On February 5, 2013, Trinity Capital Investment, LLC (“Trinity”) filed suit against the Company in California Superior Court. The complaint alleged that SemiSouth Laboratories Inc. had entered into a lease agreement with Trinity, and that the Company guaranteed SemiSouth's obligations under the lease agreement. The complaint further alleged that SemiSouth defaulted on the lease agreement in October 2012, and therefore the Company owed Trinity $2.4 million under the lease guaranty. The Company believes the complaint is without merit and will contest it vigorously.

The Company is unable to predict the outcome of legal proceedings with certainty, and there can be no assurance that Power Integrations will prevail in the above-mentioned unsettled litigations. These litigations, whether or not determined in Power Integrations' favor or settled, will be costly and will divert the efforts and attention of the Company's management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. Currently, the Company is not able to estimate a loss or a range of loss for the ongoing litigation disclosed above, however adverse determinations in litigation could result in monetary losses, the loss of proprietary rights, subject the Company to significant liabilities, require Power Integrations to seek licenses from third parties or prevent the Company from licensing the technology, any of which could have a material adverse effect on the Company's business, financial condition and operating results.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. In the quarter ended March 31, 2011, the IRS began an audit of fiscal years 2007 through 2009 which is currently in process.

13. RECENT ACCOUNTING PRONOUNCEMENTS:

In February 2013, the Financial Accounting Standards Board ("FASB") issued amendments to the FASB Accounting Standards Codification relating to the reporting of reclassifications out of accumulated other comprehensive income. The amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The Company adopted these amendments in the first quarter of 2013, and presents additional details related to other comprehensive income in Note 2, Summary of Significant Accounting Policies.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. ACQUISITION:

On May 1, 2012, the Company, through its subsidiaries Power Integrations Netherlands B.V., a Dutch company, and Power Integrations Limited, a Cayman Islands company, completed the acquisition of CT Concept Technologie AG ("Concept" or "Concept Group"), a Swiss company, by acquiring all of the outstanding shares of its Swiss parent companies Concept Beteiligungen AG and CT-Concept Holding AG (the “Acquisition”), pursuant to the Share Purchase Agreement ("Purchase Agreement") described in the Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on April 5, 2012.

The acquisition has been accounted for using the acquisition method of accounting in accordance with Accounting Standards Codification (“ASC”) 805 - Business Combinations. Under the acquisition method of accounting, the total purchase consideration of the acquisition is allocated to the tangible assets and identifiable intangible assets and liabilities assumed based on their relative fair values. The excess of the purchase consideration over the net tangible and identifiable intangible assets is recorded as goodwill, and was derived from expected benefits from technology, cost synergies and knowledgeable and experienced workforce who joined the Company after the acquisition. Goodwill is not expected to be deductible for tax purposes.

The acquisition furthers the Company's strategic aim to offer highly integrated high-voltage power-conversion products across the widest possible range of power levels and applications. While Power Integrations has historically focused on power supplies up to 500 watts of output, Concept products address higher-power applications, such as industrial motors and renewable energy systems. As such, the combination is complementary to Power Integrations' existing business. Furthermore, Concept also has an expanding addressable market and a growing, profitable revenue stream that are consistent with Power Integrations' financial goals/targets.

The following table summarizes the final purchase price of the assets acquired and the liabilities assumed as of May 1, 2012, the completion of the acquisition of Concept ("Closing Date").

		Total Amount (in thousands)
Assets Acquired		
	Cash	$14,933
	Accounts receivable	3,220
	Inventories	10,631
	Prepaid expenses and other current assets	2,777
	Property and equipment, net	2,310
	Intangible assets:	
	Developed technology	23,750
	Tradename	3,600
	Customer relationships	16,700
	Goodwill	65,813
	Total assets acquired	143,734
Liabilities assumed		
	Current liabilities	4,587
	Deferred tax liabilities	7,860
	Other liabilities	634
	Total liabilities assumed	13,081
	Total purchase price	$130,653

The fair value of intangible assets of $44.1 million has been allocated to the following three asset categories: 1) developed technology, 2) tradename and 3) customer relationships. The first two will be amortized on a straight line basis over the estimated useful life of the assets. The third intangible asset, customer relationships, will be amortized on an accelerated basis over the estimated life of the asset. The following table represents details of the purchased intangible assets as part of the acquisition:

	Fair Value Amount (in thousands)	Estimated Useful Life (in years)
Developed technology	$23,750	4 - 12
Tradename	3,600	2
Customer relationships	16,700	10
Total Concept intangibles	$44,050	