

POWER INTEGRATIONS INC  
Form 10-Q  
November 07, 2011  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

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FORM 10-Q

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(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2011

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 0-23441

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

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|  |   |
|--|---|
| DELAWARE<br>(State or other jurisdiction of<br>Incorporation or organization)<br>5245 Hellyer Avenue, San Jose, California, 95138<br>(Address of principal executive offices) (Zip code)<br>(408) 414-9200<br>(Registrant's telephone number, including area code) | 94-3065014<br>(I.R.S. Employer<br>Identification No.) |
|--|---|

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

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

|   |  |
|---|--|
| Large accelerated filer <input checked="" type="checkbox"/> | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input type="checkbox"/>              | Smaller reporting company <input type="checkbox"/> |

(Do not check if a smaller reporting company)

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

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 October 21,<br>2011 |
|-------|---|

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Common Stock, \$.001 par value

28,052,418

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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”, “outlook”, “if”, “future”, “intend”, “plan”, “estimate”, “predict”, “potential”, “targets”, “seek”, similar words and 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: our ability to maintain and establish strategic relationships; the risks inherent in the development and delivery of complex technologies; our ability to attract, retain and motivate qualified personnel; the emergence of new markets for our products and services; our ability to compete in those markets based on timeliness, cost and market demand; and our ability to procure on reasonable terms an adequate and timely supply of our products from third party manufacturers. 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 such 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)

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| <b>CURRENT ASSETS:</b>  |                       |                      |
| Cash and cash equivalents   | \$148,578             | \$155,667            |
| Short-term investments  | 48,932                | 27,355               |
| Accounts receivable, net of allowances of \$202 and \$275 in 2011 and 2010, respectively (Note 2) | 10,330                | 5,713                |
| Inventories   | 51,763                | 62,077               |
| Deferred tax assets   | 1,440                 | 1,435                |
| Prepaid expenses and other current assets   | 6,864                 | 9,263                |
| Total current assets  | 267,907               | 261,510              |
| INVESTMENTS   | 25,022                | 31,760               |
| PROPERTY AND EQUIPMENT, net   | 85,271                | 84,470               |
| INTANGIBLE ASSETS, net  | 9,066                 | 9,795                |
| GOODWILL  | 14,786                | 14,826               |
| DEFERRED TAX ASSETS   | 12,637                | 13,421               |
| OTHER ASSETS  | 25,799                | 17,288               |
| Total assets  | \$440,488             | \$433,070            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                      |
| <b>CURRENT LIABILITIES:</b>   |                       |                      |
| Accounts payable  | \$17,318              | \$20,291             |
| Accrued payroll and related expenses  | 6,290                 | 7,395                |
| Taxes payable   | 1,759                 | —                    |
| Deferred income on sales to distributors  | 10,316                | 12,221               |
| Other accrued liabilities   | 2,613                 | 9,548                |
| Total current liabilities   | 38,296                | 49,455               |
| LONG-TERM INCOME TAXES PAYABLE  | 33,805                | 29,580               |
| Total liabilities   | 72,101                | 79,035               |
| <b>COMMITMENTS AND CONTINGENCIES (Notes 9, 11 and 12)</b>   |                       |                      |
| <b>STOCKHOLDERS' EQUITY:</b>  |                       |                      |
| Common stock  | 28                    | 28                   |
| Additional paid-in capital  | 166,007               | 175,295              |
| Accumulated other comprehensive income  | 80                    | 85                   |
| Retained earnings   | 202,272               | 178,627              |
| Total stockholders' equity  | 368,387               | 354,035              |
| Total liabilities and stockholders' equity  | \$440,488             | \$433,070            |

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  
 (unaudited)  
 (In thousands, except per share amounts)

|  | Three Months Ended |          | Nine Months Ended |           |
|--|--------------------|----------|-------------------|-----------|
|  | September 30,      |          | September 30,     |           |
|  | 2011               | 2010     | 2011              | 2010      |
| NET REVENUES                             | \$75,063           | \$75,452 | \$232,009         | \$226,817 |
| COST OF REVENUES                         | 40,020             | 36,447   | 122,917           | 110,402   |
| GROSS PROFIT                             | 35,043             | 39,005   | 109,092           | 116,415   |
| OPERATING EXPENSES:                      |                    |          |                   |           |
| Research and development                 | 10,345             | 9,348    | 30,563            | 26,133    |
| Sales and marketing                      | 7,990              | 7,657    | 24,342            | 22,104    |
| General and administrative               | 6,145              | 6,746    | 18,761            | 19,223    |
| Total operating expenses                 | 24,480             | 23,751   | 73,666            | 67,460    |
| INCOME FROM OPERATIONS                   | 10,563             | 15,254   | 35,426            | 48,955    |
| OTHER INCOME                             |                    |          |                   |           |
| Other income, net                        | 552                | 415      | 1,455             | 1,379     |
| Total other income                       | 552                | 415      | 1,455             | 1,379     |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 11,115             | 15,669   | 36,881            | 50,334    |
| PROVISION FOR INCOME TAXES               | 3,603              | 3,035    | 8,916             | 9,800     |
| NET INCOME                               | \$7,512            | \$12,634 | \$27,965          | \$40,534  |
| EARNINGS PER SHARE:                      |                    |          |                   |           |
| Basic                                    | \$0.26             | \$0.45   | \$0.97            | \$1.46    |
| Diluted                                  | \$0.25             | \$0.43   | \$0.93            | \$1.38    |
| SHARES USED IN PER SHARE CALCULATION:    |                    |          |                   |           |
| Basic                                    | 28,799             | 27,894   | 28,789            | 27,737    |
| Diluted                                  | 29,879             | 29,283   | 30,195            | 29,406    |

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)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2011                               | 2010      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |           |
| Net income  | \$27,965                           | \$40,534  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |           |
| Depreciation  | 11,337                             | 8,974     |
| Amortization of intangibles   | 729                                | 504       |
| Gain on sale of property and equipment  | (41                                | ) (344    |
| Stock-based compensation expense  | 6,617                              | 7,459     |
| Amortization of premium on held to maturity investments                           | 1,255                              | 1,337     |
| Deferred income taxes   | 779                                | 249       |
| Decrease in accounts receivable allowances  | (74                                | ) (25     |
| Excess tax benefit from stock options exercised                                   | (729                               | ) (939    |
| Tax benefit associated with employee stock plans                                  | 1,826                              | 1,951     |
| Change in operating assets and liabilities:                                       |                                    |           |
| Accounts receivable   | (4,542                             | ) 13,854  |
| Inventories   | 10,184                             | (22,796   |
| Prepaid expenses and other assets   | 2,823                              | 4,610     |
| Accounts payable  | (1,090                             | ) 93      |
| Taxes payable and accrued liabilities   | 4,891                              | 4,305     |
| Deferred income on sales to distributors  | (1,904                             | ) 5,808   |
| Net cash provided by operating activities   | 60,026                             | 65,574    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |           |
| Purchases of property and equipment   | (16,229                            | ) (21,833 |
| Proceeds from sale of property and equipment                                      | 2,249                              | 1,415     |
| Other assets  | (1,271                             | ) —       |
| Acquisition (Note 14)   | (6,914                             | ) (8,598  |
| Increase in financing lease receivables   | (7,978                             | ) —       |
| Collections of financing lease receivable   | 314                                | —         |
| Note to third party   | (3,000                             | ) (6,750  |
| Collection of note to third party   | 3,000                              | —         |
| Purchases of held-to-maturity investments   | (31,269                            | ) (27,224 |
| Proceeds from maturities of held-to-maturity investments                          | 15,175                             | 26,491    |
| Net cash used in investing activities   | (45,923                            | ) (36,499 |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |           |
| Issuance of common stock under employee stock plans                               | 18,218                             | 17,987    |
| Repurchase of common stock  | (35,819                            | ) (13,960 |
| Retirement of shares for income tax withholding                                   | —                                  | (769      |
| Payments of dividends to stockholders   | (4,320                             | ) (4,163  |
| Excess tax benefit from stock options exercised                                   | 729                                | 939       |
| Net cash (used in) provided by financing activities                               | (21,192                            | ) 34      |

|  |           |           |
|--|-----------|-----------|
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (7,089    | ) 29,109  |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD     | 155,667   | 134,974   |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD           | \$148,578 | \$164,083 |

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

|   |         |         |
|---|---------|---------|
| Unpaid property and equipment   | \$3,486 | \$1,008 |
| Conversion of notes receivable in connection with acquisition (Note 14) | \$—     | \$1,752 |
| Application of prepayment to acquisition (Note 14)                      | \$—     | \$1,200 |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

|  |       |         |
|--|-------|---------|
| Cash paid for income taxes, net of refunds | \$553 | \$1,951 |
|--|-------|---------|

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



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

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.

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, 2010 included in its Form 10-K/A filed on June 15, 2011 with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

No significant 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/A, filed on June 15, 2011, for the year ended December 31, 2010. 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.

Short-Term and Long-Term Investments

Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of September 30, 2011 and December 31, 2010, the Company's short-term and long-term investments consisted of U.S. government backed securities, municipal bonds, corporate commercial paper, certificates of deposit and other high-quality commercial securities, which were classified as held-to-maturity and were valued using the amortized-cost method, which approximates fair market value.

Amortized cost and estimated fair market value of investments classified as held-to-maturity at September 30, 2011, are as follows (in thousands):

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|   | Amortized Cost | Gross Unrealized |          | Estimated Fair Market Value |
|---|----------------|------------------|----------|-----------------------------|
|   |                | Gains            | Losses   |                             |
| Investments due in less than 3 months:  |                |                  |          |                             |
| Commercial paper                        | \$7,000        | \$—              | \$—      | \$7,000                     |
| Corporate securities                    | 11,602         | 4                | (1 )     | 11,605                      |
| Total                                   | \$18,602       | \$4              | \$(1 )   | \$18,605                    |
| Investments due in 4-12 months:         |                |                  |          |                             |
| Corporate securities                    | \$27,330       | \$241            | (30 )    | \$27,541                    |
| Certificates of deposit                 | 10,000         | 8                | —        | 10,008                      |
| Total                                   | \$37,330       | \$249            | (30 )    | \$37,549                    |
| Investments due in more than 12 months: |                |                  |          |                             |
| Corporate securities                    | \$25,022       | \$25             | \$(141 ) | \$24,906                    |
| Total                                   | \$25,022       | \$25             | \$(141 ) | \$24,906                    |
| Total investment securities             | \$80,954       | \$278            | \$(172 ) | \$81,060                    |

Amortized cost and estimated fair market value of investments classified as held-to-maturity at December 31, 2010 are as follows (in thousands):

|   | Amortized Cost | Gross Unrealized |        | Estimated Fair Market Value |
|---|----------------|------------------|--------|-----------------------------|
|   |                | Gains            | Losses |                             |
| Investments due in less than 3 months:  |                |                  |        |                             |
| Commercial paper                        | \$7,135        | \$—              | \$—    | \$7,135                     |
| Corporate securities                    | 1,508          | —                | (1 )   | 1,507                       |
| Total                                   | \$8,643        | \$—              | \$(1 ) | \$8,642                     |
| Investments due in 4-12 months:         |                |                  |        |                             |
| Corporate securities                    | \$21,255       | \$84             | \$—    | \$21,339                    |
| U.S. government securities              | 5,095          | 20               | —      | 5,115                       |
| U.S. municipal securities               | 1,005          | 3                | —      | 1,008                       |
| Total                                   | \$27,355       | \$107            | \$—    | \$27,462                    |
| Investments due in more than 12 months: |                |                  |        |                             |
| Corporate securities                    | \$31,760       | \$648            | \$—    | \$32,408                    |
| Total                                   | \$31,760       | \$648            | \$—    | \$32,408                    |
| Total investment securities             | \$67,758       | \$755            | \$(1 ) | \$68,512                    |
| Revenue Recognition                     |                |                  |        |                             |

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Shipping terms to international OEM customers and merchant power supply manufacturers from the Company's facility in California are “delivered at frontier” (“DAF”). 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. Shipping terms to international OEMs and merchant power supply manufacturers on shipments from the Company's facility outside of the United States are “EX Works” (“EXW”), 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 “free on board” (“FOB”) point of origin 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 as described below.

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 customer. The Company considers the price to be fixed based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary.

The Company makes sales to distributors and retail partners and recognizes revenue based on a sell-through method. Sales to distributors are made under terms allowing certain price protection and rights of return on the Company's products held by the 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 such distributors resell the Company's products to their customers. The Company determines the amounts to defer based on the level of actual inventory on hand at the distributors as well as inventory in transit to the distributors. 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 September 30, 2011 and December 31, 2010 was approximately \$22.1 million and \$24.7 million, respectively. The total deferred cost as of September 30, 2011 and December 31, 2010 was approximately \$11.8 million and \$12.5 million, respectively.

Common Stock Repurchases and Common Stock Dividend

In May 2009, the Company's board of directors authorized the use of \$25.0 million to repurchase the Company's common stock. From May 2009 to December 31, 2009 the Company purchased 0.5 million shares for approximately \$11.0 million, and in the first two quarters of 2010 the Company purchased 0.4 million shares for approximately \$14.0 million, concluding this repurchase program.

In February 2011, the board of directors authorized the use of an additional \$50.0 million for the repurchase of the Company's common stock, with repurchases to be executed according to certain pre-defined price/volume guidelines set by the board of directors. In the nine months ended September 30, 2011, the Company repurchased 1.1 million shares for a total cost of \$35.8 million, leaving \$14.2 million remaining for future repurchases. There is currently no expiration date for this stock repurchase program.

In January 2010, 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 2010. The quarterly dividend payments were made on March 31, 2010, June 30, 2010, September 30, 2010 and December 31, 2010, to stockholders of record as of February 26, 2010, May 28, 2010, August 31, 2010 and November 30, 2010, respectively, each in the aggregate amount of approximately \$1.4 million.

In October 2010, 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 2011. The first quarterly dividend payment of approximately \$1.4 million was made on March 31, 2011, to stockholders of record as of February 28, 2011, the second quarterly dividend payment of \$1.4 million was made on June 30, 2011 to stockholders of record as of May 31, 2011 and the third payment of \$1.4 million was made on September 30, 2011 to stockholders of record as of August 31, 2011. The Company expects that the remaining quarterly dividend will result in a similar use of cash. 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 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.

#### Comprehensive Income

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Comprehensive income consists of net income, plus the effect of foreign currency translation adjustments. The components of comprehensive income, net of taxes, are as follows (in thousands):

|                             | Three Months Ended |          | Nine Months Ended |          |
|-----------------------------|--------------------|----------|-------------------|----------|
|                             | September 30,      |          | September 30,     |          |
|                             | 2011               | 2010     | 2011              | 2010     |
| Net income                  | \$7,512            | \$12,634 | \$27,965          | \$40,534 |
| Other comprehensive income: |                    |          |                   |          |
| Translation adjustments     | (78                | ) 105    | (5                | ) 50     |
| Total comprehensive income  | \$7,434            | \$12,739 | \$27,960          | \$40,584 |

Components of the Company's Condensed Consolidated Balance Sheet

Accounts Receivable (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2011          | 2010         |
| Accounts receivable trade                | \$32,764      | \$30,656     |
| Accrued ship and debit and rebate claims | (22,232       | ) (24,839    |
| Allowance for doubtful accounts          | (202          | ) (275       |
| Other                                    | —             | 171          |
| Total                                    | \$10,330      | \$5,713      |

Prepaid Expenses and Other Current Assets (in thousands):

|                                | September 30, | December 31, |
|--------------------------------|---------------|--------------|
|                                | 2011          | 2010         |
| Prepaid legal fees             | \$1,000       | \$4,000      |
| Prepaid inventory (Note 16)    | —             | 917          |
| Prepaid income tax             | 1,351         | 1,117        |
| Prepaid maintenance agreements | 786           | 554          |
| Interest receivable            | 788           | 737          |
| Other                          | 2,939         | 1,938        |
| Total                          | \$6,864       | \$9,263      |

Other Assets (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2011          | 2010         |
| Prepaid royalty (Note 15)                          | \$10,000      | \$10,000     |
| Investment in third party (Note 15)                | 7,000         | 7,000        |
| Financing lease receivables and deposits (Note 17) | 7,215         | —            |
| Other  | 1,584         | 288          |
| Total  | \$25,799      | \$17,288     |

Other Accrued Liabilities (in thousands):

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Accrued payment for acquisition (Note 14) | \$—                   | \$6,955              |
| Accrued professional fees                 | 1,354                 | 1,013                |
| Accrued expense for engineering wafers    | 529                   | 502                  |
| Advances from customers                   | 498                   | 713                  |
| Other                                     | 232                   | 365                  |
| Total                                     | \$2,613               | \$9,548              |

## 3. STOCK PLANS AND SHARE BASED COMPENSATION:

## Stock Plans

As of September 30, 2011, the Company had five 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 stock awards and other stock awards to employees, directors and consultants. As of September 30, 2011, the maximum remaining number of shares that may be issued under the 2007 Plan was 6,825,949 shares, which consists of the 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 provides in certain circumstances (depending on the status of the particular director's holdings of Company stock options) for the automatic 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 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 1<sup>st</sup>; 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. 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 Stock Option Plan

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the "1997 Plan"), whereby the board of directors could grant incentive stock options and nonstatutory stock options to purchase the Company's common stock to key employees, directors and consultants. The exercise price of incentive stock options could not be less than 100% of the fair market value of the Company's common stock on the date of grant. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. Effective November 2007, the board of directors determined that no further options would be granted under the 1997 Plan, and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options under the 1997 Plan were transferred to the 2007 Equity Incentive Plan. All outstanding options would continue to be governed and remain outstanding in accordance with their



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existing terms.

#### 1997 Outside Directors Stock Option Plan

In September 1997, the board of directors adopted the 1997 Outside Directors Stock Option Plan (the "Directors Plan"). A total of 800,000 shares of common stock have been reserved for issuance under the Directors Plan. The exercise price per share of all options granted under the Directors Plan is equal to the fair market value of a share of common stock on the date of grant. Options granted under the Directors Plan have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of service. The Directors Plan provides that each future nonemployee director of the Company will be granted an option to purchase 30,000 shares on which such individual first becomes a nonemployee director of the Company (the "Initial Grant"). Thereafter, each nonemployee director who has served on the board of directors continuously for 12 months will be granted an additional option to purchase 10,000 shares of common stock (an "Annual Grant"). Approximately 1/3<sup>rd</sup> of Initial Grants became exercisable one year after the date of grant and 1/36<sup>th</sup> of the Initial Grant will become exercisable monthly thereafter. Each Annual Grant will become exercisable in twelve equal monthly installments beginning in the 25th month after the date of grant, subject to the optionee's continuous service. In the event of certain changes in control of the Company, all options outstanding under the Directors Plan will become immediately vested and exercisable in full. The board of directors suspended grants under the Directors Plan, and nonemployee directors have received, and will receive, initial and annual grants primarily under the Power Integrations 2007 Equity Incentive Plan (described above) pursuant to the "Directors Equity Compensation Program" (see description above). The suspension of grants under the Directors Plan is indefinite, and will last until the board of directors or compensation committee determines that grants under the Directors Plan will no longer be suspended.

On July 28, 2009, the Directors Plan was amended generally to prohibit outstanding options from being amended 1) to reduce the exercise price of such outstanding options or 2) canceled in exchanged for cash, other awards or options with a lower exercise price without stockholder approval.

#### 1998 Nonstatutory Stock Option Plan

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the "1998 Plan"); whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to the extent that such options do not require approval of the Company's stockholders. The 1998 Plan has not been approved by the Company's stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. As of September 30, 2011, the maximum number of shares that may be issued under the 1998 Plan was 1.0 million and as of that date no shares are available for future issuance. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

On July 28, 2009, the 1998 Plan was amended generally to prohibit outstanding options from being amended 1) to reduce the exercise price of such outstanding options or 2) canceled in exchanged for cash, other awards or options with a lower exercise price 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 September 30, 2011, 2,345,615 shares had been purchased and 654,385 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,

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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 as an average of implied volatility and historical volatility.

**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 nine months ended September 30, 2011 and September 30, 2010 (in thousands).

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2011                                | 2010     | 2011                               | 2010     |
| Cost of revenues                       | \$ 128                              | \$ 153   | \$ 584                             | \$ 481   |
| Research and development               | 564                                 | 1,125    | 2,354                              | 2,782    |
| Sales and marketing                    | 449                                 | 727      | 1,659                              | 1,776    |
| General and administrative             | 527                                 | 930      | 2,020                              | 2,438    |
| Total stock-based compensation expense | \$ 1,668                            | \$ 2,935 | \$ 6,617                           | \$ 7,477 |

As of September 30, 2011 there were approximately \$6.7 million, net of expected forfeitures, of total unrecognized compensation expense related to stock options. The unrecognized compensation expense at September 30, 2011 is expected to be recognized over a weighted-average period of 2.0 years.

As of September 30, 2011, the Company had \$11.7 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock units. The unamortized compensation expense will be recognized on a straight-line basis over a weighted-average period of 3.2 years.

As of September 30, 2011, the total unrecognized compensation cost under the Purchase Plan to purchase the Company's common stock was approximately \$0.4 million. The Company will amortize this cost on a straight-line basis over approximately 0.5 years.

Stock compensation expense in the three months ended September 30, 2011 was \$1.7 million (comprised of approximately \$1.0 million related to stock options, a reduction of \$0.7 million related to performance shares that are not expected to vest in 2011 (see the performance-based awards section below for details), \$1.1 million related to restricted stock units and \$0.3 million related to the Purchase Plan). Stock compensation expense in the nine months ended September 30, 2011 was \$6.6 million (comprised of approximately \$3.1 million related to stock options, \$2.5 million related to restricted stock

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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

units, \$0.9 million related to the Purchase Plan and \$0.1 million in compensation expense amortized from beginning inventory).

Stock compensation expense in the three and nine months ended September 30, 2010, was \$2.9 million (comprised of approximately \$1.3 million related to stock options, \$1.0 million related to performance shares, \$0.5 million related to restricted stock units, \$0.2 million related to the Purchase Plan, partially offset by \$0.1 million in compensation expense capitalized into inventory) and \$7.5 million (comprised of approximately \$4.0 million related to stock options, \$2.0 million related to performance shares, \$0.8 million related to restricted stock units, \$0.8 million related to the Purchase Plan, partially offset by \$0.1 million in compensation expense capitalized into inventory), respectively.

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 |         | Nine Months Ended |               |
|---|--------------------|---------|-------------------|---------------|
|   | September 30,      |         | September 30,     |               |
|   | 2011               | 2010    | 2011              | 2010          |
| Risk-free interest rates                                  | 1.46%              | 1.53%   | 1.46% - 2.20%     | 1.53% - 2.25% |
| Expected volatility rates                                 | 44%                | 45%     | 44%               | 45% - 48%     |
| Expected dividend yield                                   | 0.59%              | 0.62%   | 0.54% - 0.59%     | 0.54% - 0.62% |
| Expected term of stock options (in years)                 | 6.00               | 5.12    | 6.00              | 5.12          |
| Weighted-average grant date fair value of options granted | \$15.58            | \$12.61 | \$15.66           | \$14.82       |

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 |        | Nine Months Ended |               |
|--|--------------------|--------|-------------------|---------------|
|  | September 30,      |        | September 30,     |               |
|  | 2011               | 2010   | 2011              | 2010          |
| Risk-free interest rates                                 | 0.16%              | 0.20%  | 0.16% - 0.17%     | 0.17% - 0.20% |
| Expected volatility rates                                | 37%                | 43%    | 37%               | 36% - 43%     |
| Expected dividend yield                                  | 0.59%              | 0.62%  | 0.51% - 0.59%     | 0.34% - 0.62% |
| Expected term of purchase right (years)                  | 0.50               | 0.50   | 0.50              | 0.50          |
| Weighted-average estimated fair value of purchase rights | \$8.93             | \$9.49 | \$9.15            | \$8.65        |

A summary of stock option activity under the Plans, excluding performance-based shares and restricted stock units, as of September 30, 2011, and changes during the nine months then ended, is presented below:

|                                | Shares<br>(in thousands) | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic Value<br>(in thousands) |
|--------------------------------|--------------------------|---|--|--|
| Outstanding at January 1, 2011 | 4,433                    | \$22.68                                   |  |  |
| Granted                        | 164                      | 37.37                                     |  |  |
| Exercised                      | (734)                    | ) 19.63                                   |  |  |
| Forfeited or expired           | (63)                     | ) 25.02                                   |  |  |

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|   |       |         |      |          |
|---|-------|---------|------|----------|
| Outstanding at September 30, 2011                 | 3,800 | \$23.87 | 4.83 | \$27,924 |
| Exercisable at September 30, 2011                 | 3,119 | \$22.90 | 4.08 | \$24,599 |
| Vested and expected to vest at September 30, 2011 | 3,760 | \$23.76 | 4.79 | \$27,854 |

The total intrinsic value of options exercised during the three and nine months ended September 30, 2011 was \$1.8 million and \$13.4 million, respectively, and the intrinsic value of options exercised during the three and nine months ended September 30, 2010 was \$1.1 million and \$18.4 million, respectively.

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## 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 and non-GAAP operating earnings. 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 nine months ended September 30, 2011, the Company issued approximately 98,000 performance-based awards to employees and executives. As the net revenue and non-GAAP operating earnings 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. The Company does not believe the net revenue and non-GAAP operating earnings performance targets will be met in 2011, and therefore reversed \$0.7 million of previously recognized expense during the three months ended September 30, 2011.

In January 2011, it was determined that the Company had reached the maximum level of the established performance targets for the performance-based awards granted in 2010. Accordingly, the 85,000 performance-based awards, which were fully vested, were released to the Company's employees and executives in the first quarter of 2011.

A summary of performance-based awards outstanding as of September 30, 2011, and activity during the nine months then ended, is presented below:

|   | Shares<br>(in<br>thousands) | Weighted-<br>Average<br>Grant Date<br>Fair Value<br>Per Share | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|---|-----------------------------|---|---|--|
| Outstanding at January 1, 2011                    | 85                          | \$34.97   |   |  |
| Granted   | 98                          | 36.57   |   |  |
| Vested  | (85 )                       | 34.97   |   |  |
| Forfeited or expired                              | (6 )                        | 36.61   |   |  |
| Outstanding at September 30, 2011                 | 92                          | \$36.57   | 0.25  | \$2,817  |
| Vested and expected to vest at September 30, 2011 | —                           |   | 0.25  | \$—  |

The weighted-average grant-date fair value per share of performance-based awards granted in the three months ended September 30, 2011 was approximately \$30.58, there were no performance-based awards granted in the three months ended September 30, 2010. The weighted-average grant-date fair value per share of performance-based awards granted in the nine months ended September 30, 2011 and 2010 was approximately \$36.57 and \$34.86, respectively. The grant date fair value of awards released, which were fully vested, in the nine months ended September 30, 2011 and 2010 was approximately \$3.0 million and \$2.3 million, respectively. There were no performance-based awards released in either of the three months ended September 30, 2011 and September 30, 2010.

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 cost of the 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 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 September 30, 2011, and changes during the nine months then ended, is as



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follows:

|  | Shares<br>(in<br>thousands) | Weighted-<br>Average<br>Grant Date<br>Fair Value<br>Per Share | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|--|-----------------------------|---|---|---|
| Outstanding at January 1, 2011                         | 260                         | \$36.30   |   |   |
| Granted  | 253                         | 36.16   |   |   |
| Vested   | (58 )                       | 36.30   |   |   |
| Forfeited or expired                                   | (25 )                       | 37.28   |   |   |
| Outstanding at September 30, 2011                      | 430                         | \$36.16   | 1.89  | \$13,154  |
| Outstanding and expected to vest at September 30, 2011 | 379                         |   | 1.87  | \$11,591  |

The weighted-average grant-date fair value of RSUs awarded in the three and nine months ended September 30, 2011 was approximately \$33.21 and \$36.16, respectively. The weighted-average grant-date fair value of RSUs awarded in the three and nine months ended September 30, 2010 was approximately \$33.71 and \$36.53, respectively. The grant date fair value of awards vested in the three and nine months ended September 30, 2011 was approximately \$0.2 million and \$2.1 million, respectively; and \$17,000 in the three months ended September 30, 2010. No RSUs vested in the first six months of 2010.

## 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, when available, 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. The Company's investments classified as Level 1 and Level 2 are held-to-maturity investments, and were valued using the amortized-cost method, which approximates fair market value.

On October 22, 2010, the Company entered into an agreement with SemiSouth Laboratories, pursuant to which, among other things, the Company may be obligated to acquire SemiSouth if SemiSouth meets certain financial performance conditions on or before June 30, 2013. At September 30, 2011, the Company determined the fair value of

this potential obligation to be zero. The Company used Level 2 inputs in its fair market valuation using a market approach valuation technique and determined the fair value of this obligation to be zero. The Company derived the Level 2 inputs principally from corroborated observable market data (i.e., correlation values). See Note 15, Investment in Third Party, below for further details on the valuation method used. The Company updates the estimated fair value of this potential obligation quarterly. Any changes are recorded in its unaudited condensed consolidated statements of income.

The fair value hierarchy of the Company's marketable securities and investments at September 30, 2011 and December 31, 2010, was as follows (in thousands):

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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| Description             | Fair Value Measurement at<br>September 30, 2011 |   |   |
|-------------------------|---|---|---|
|                         | September 30, 2011                              | Quoted Prices in<br>Active Markets for<br>Identical Assets (Level<br>1) | Significant Other<br>Observable Inputs<br>(Level 2) |
| Commercial paper        | \$7,000   | \$—   | \$7,000   |
| Money market funds      | 33,827  | 33,827  | —   |
| Certificates of deposit | 10,000  | —   | 10,000  |
| Corporate securities    | 63,954  | —   | 63,954  |
| Total                   | \$114,781                                       | \$33,827  | \$80,954  |

| Description                     | Fair Value Measurement at<br>December 31, 2010 |   |   |
|---------------------------------|--|---|---|
|                                 | December 31, 2010                              | Quoted Prices in<br>Active Markets for<br>Identical Assets (Level<br>1) | Significant Other<br>Observable Inputs<br>(Level 2) |
| Commercial paper                | \$7,135  | \$—   | \$7,135   |
| Money market funds              | 52,951   | 52,951  | —   |
| U.S. Government debt securities | 6,100  | —   | 6,100   |
| Corporate securities            | 54,523   | —   | 54,523  |
| Total                           | \$120,709                                      | \$52,951  | \$67,758  |

The Company did not transfer any investments between level 1 and level 2 of the fair value hierarchy in the nine months ended September 30, 2011 and the twelve months ended December 31, 2010.

The Company was issued a \$3.0 million note from SemiSouth in the second quarter of 2011, which was classified as Level 3 in the fair value hierarchy. The note was classified as Level 3 as there was no market data for this instrument. The Company held the note to maturity, which occurred on August 15, 2011. The following table presents the changes in Level 3 investments for the nine months ended September 30, 2011 (in thousands):

|                                      | Fair Value Measurement Using<br>Significant Unobservable Inputs<br>(Level 3)<br>Note Receivable |
|--------------------------------------|---|
| Beginning balance at January 1, 2011 | \$—   |
| Purchases and issuances              | 3,000   |
| Settlements                          | (3,000)   |
| Ending balance at September 30, 2011 | \$—   |

## 5. INVENTORIES:

Inventories (which consist of costs associated with the purchases of wafers from 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):



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|                 | September 30,<br>2011 | December 31,<br>2010 |
|-----------------|-----------------------|----------------------|
| Raw materials   | \$9,636               | \$20,334             |
| Work-in-process | 10,144                | 13,171               |
| Finished goods  | 31,983                | 28,572               |
| Total           | \$51,763              | \$62,077             |

## 6. GOODWILL AND INTANGIBLE ASSETS:

The carrying amount of goodwill was \$14.8 million as of September 30, 2011 and December 31, 2010.

Intangible assets consist primarily of acquired licenses, in-process research and development and patent rights, and are reported net of accumulated amortization. In August 2010, the Company acquired an early-stage research and development company, resulting in the addition of in-process research and development of \$4.7 million. In December 2010, the Company acquired Qspeed Semiconductor resulting in the addition of customer relationships of \$0.9 million, and developed technology of \$1.8 million (see Note 14, Acquisitions, below). The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the acquired license or patent rights, which range from five to ten years, with the exception of \$4.7 million of in-process research and development which will be amortized once the development is completed and products are available for sale. The Company does not expect the amortization for its in-process research and development to begin in 2011. Amortization for acquired intangible assets was approximately \$0.2 million and \$0.2 million in the three months ended September 30, 2011 and September 30, 2010, respectively, and \$0.7 million and \$0.5 million in the nine months ended September 30, 2011 and 2010, respectively. The Company does not believe there is any significant residual value associated with the following intangible assets:

|                                     | September 30, 2011 |                             |           | December 31, 2010 |                             |           |
|-------------------------------------|--------------------|-----------------------------|-----------|-------------------|-----------------------------|-----------|
|                                     | Gross              | Accumulated<br>Amortization | Net       | Gross             | Accumulated<br>Amortization | Net       |
|                                     | (in thousands)     |                             |           |                   |                             |           |
| In-process research and development | \$4,690            | \$—                         | \$4,690   | \$4,690           | \$—                         | \$4,690   |
| Technology licenses                 | 3,000              | (1,650)                     | ) 1,350   | 3,000             | (1,425)                     | ) 1,575   |
| Patent rights                       | 1,949              | (1,922)                     | ) 27      | 1,949             | (1,760)                     | ) 189     |
| Developed technology                | 2,920              | (746)                       | ) 2,174   | 2,920             | (489)                       | ) 2,431   |
| Customer relationships              | 910                | (85)                        | ) 825     | 910               | —                           | ) 910     |
| Other intangibles                   | 37                 | (37)                        | ) —       | 37                | (37)                        | ) —       |
| Total intangible assets             | \$13,506           | \$(4,440)                   | ) \$9,066 | \$13,506          | \$(3,711)                   | ) \$9,795 |

The estimated future amortization expense related to intangible assets at September 30, 2011 is as follows:

| Fiscal Year               | Estimated<br>Amortization<br>(in thousands) |
|---------------------------|---|
| 2011 (remaining 3 months) | \$214                                       |
| 2012                      | 755   |
| 2013                      | 755   |
| 2014                      | 754   |

|            |         |
|------------|---------|
| 2015       | 592     |
| Thereafter | 1,306   |
| Total (1)  | \$4,376 |

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

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## 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 proprietary, high-voltage, analog integrated circuits for use primarily in the AC-DC power conversion markets. 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 65% and 64% of net revenues for the three months ended September 30, 2011 and September 30, 2010, respectively, and 65% and 64% of revenues for the nine months ended September 30, 2011 and September 30, 2010, 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:

| Customer | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |      |      |
|----------|-------------------------------------|------|------------------------------------|------|------|------|
|          | 2011                                | 2010 | 2011                               | 2010 | 2011 | 2010 |
| A        | 19                                  | % 18 | % 19                               | % 16 | %    | %    |
| B        | 12                                  | % 11 | % 12                               | % 11 | %    | %    |

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 September 30, 2011 and December 31, 2010, 71% and 76%, respectively, of accounts receivable were concentrated with the Company's top 10 customers. The following customers represented 10% or more of accounts receivable:

| Customer | September 30,<br>2011 | December 31,<br>2010 |
|----------|-----------------------|----------------------|
| A        | 21                    | % 21                 |
| B        | 15                    | % *                  |

\*less than 10%

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 through its sales personnel and a worldwide network of distributors. As a

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

percentage of total net revenues, international sales, which consist of domestic and foreign sales to distributors and direct customers outside of the Americas, are comprised of the following:

|                                    | Three Months Ended |      | Nine Months Ended |      |   |
|------------------------------------|--------------------|------|-------------------|------|---|
|                                    | September 30,      |      | September 30,     |      |   |
|                                    | 2011               | 2010 | 2011              | 2010 |   |
| Hong Kong/China                    | 40                 | % 35 | % 38              | % 32 | % |
| Taiwan                             | 18                 | % 23 | % 21              | % 24 | % |
| Korea                              | 16                 | % 18 | % 16              | % 19 | % |
| Western Europe (excluding Germany) | 10                 | % 9  | % 10              | % 8  | % |
| Japan                              | 7                  | % 5  | % 6               | % 6  | % |
| Singapore                          | 2                  | % 2  | % 2               | % 2  | % |
| Germany                            | 1                  | % 1  | % 1               | % 2  | % |
| Other                              | 2                  | % 1  | % 2               | % 2  | % |
| Total foreign revenue              | 96                 | % 94 | % 96              | % 95 | % |

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

## Product Sales

Approximately 97% to 99% of the Company's sales in the three and nine months ended September 30, 2011 and 2010, respectively, were from its three primary groupings of low-power AC-DC power-conversion products - TOPSwitch, TinySwitch and LinkSwitch. Approximately 1% to 3% of the Company's sales came from other product families, principally the Company's DPA-Switch family of high-voltage DC-DC products, and in the first three quarters of 2011, the Company's Hiper family of products which includes both power-conversion and power-factor-correction products for high-power applications.

Revenue mix by product family for the three and nine months ended September 30, 2011 and 2010 was as follows:

| Product Family | Three Months Ended |      | Nine Months Ended |      |   |
|----------------|--------------------|------|-------------------|------|---|
|                | September 30,      |      | September 30,     |      |   |
|                | 2011               | 2010 | 2011              | 2010 |   |
| LinkSwitch     | 43                 | % 39 | % 42              | % 37 | % |
| TinySwitch     | 33                 | % 37 | % 33              | % 38 | % |
| TOPSwitch      | 21                 | % 23 | % 23              | % 24 | % |
| Other          | 3                  | % 1  | % 2               | % 1  | % |

## 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.

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



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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|  | Three Months Ended |          | Nine Months Ended |          |
|--|--------------------|----------|-------------------|----------|
|  | September 30,      |          | September 30,     |          |
|  | 2011               | 2010     | 2011              | 2010     |
| Basic earnings per share:              |                    |          |                   |          |
| Net income                             | \$7,512            | \$12,634 | \$27,965          | \$40,534 |
| Weighted-average common shares         | 28,799             | 27,894   | 28,789            | 27,737   |
| Basic earnings per share               | \$0.26             | \$0.45   | \$0.97            | \$1.46   |
| Diluted earnings per share (1):        |                    |          |                   |          |
| Net income                             | \$7,512            | \$12,634 | \$27,965          | \$40,534 |
| Weighted-average common shares         | 28,799             | 27,894   | 28,789            | 27,737   |
| Effect of dilutive securities:         |                    |          |                   |          |
| Employee stock plans                   | 1,080              | 1,389    | 1,406             | 1,669    |
| Diluted weighted-average common shares | 29,879             | 29,283   | 30,195            | 29,406   |
| Diluted earnings per share             | \$0.25             | \$0.43   | \$0.93            | \$1.38   |

(1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share when they become contingently issuable per ASC 260-10, Earnings per Share and excludes such shares when they are not contingently issuable. The Company has excluded all performance-based awards underlying the fiscal 2011 and 2010 awards as those shares were not contingently issuable as of the end of the period.

Approximately 410,000 shares and 530,000 shares attributable to stock-based awards for the three months ended September 30, 2011 and 2010, respectively, and 276,000 shares and 139,000 shares attributable to stock-based awards for the nine months ended September 30, 2011 and 2010, respectively, were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive.

#### 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. The Company limits the deferred tax assets recognized related to certain highly-paid officers of the Company to amounts that it estimates will be deductible in future periods based upon the provisions of the Internal Revenue Code Section 162(m). 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 September 30, 2011, the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets as the Company believes that it is not more likely than not that the deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

Income tax expense includes a provision for 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 nine months ended September 30, 2011 were 32.4% and 24.2%, respectively. The difference between the expected statutory rate of 35% and the Company's effective tax rate for

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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the three and nine months ended September 30, 2011 was primarily due to the beneficial impact of the geographic distribution of the Company's world-wide earnings and the beneficial impact of a research and experimentation tax credit. The difference between the expected statutory rate of 35% and the Company's effective tax rate of 19.4% and 19.5% for the three and nine months ended September 30, 2010, respectively, was due primarily to the beneficial impact of the geographic distribution of the Company's world-wide earnings, and the favorable impact from the expected federal investment tax credit on the Company's solar-power installation.

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 informed the Company that the IRS intends to propose adjustments to the Company's taxable income for fiscal years 2003 through 2006 related to the Company's intercompany research and development cost-sharing arrangement and related issues. The Company believes that the IRS position is without merit and intends to defend its tax return position vigorously. The fiscal years 2007 through 2009 are also under audit by the IRS.

Determining the consolidated provision for 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.

#### 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 September 30, 2011. 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:

The Company purchases wafers through purchase orders from its foundries. All but one of the Company's wafer agreements were executed in U.S. currency. Until June 2011, this one foundry required wafer purchases to be in Japanese yen; however, the purchase price within this agreement was fixed at a base rate and allowed for some sharing of the impact of exchange rate fluctuations from the base rate. The currency fluctuation experienced between the time

invoices were submitted to the Company until the time the yen was purchased and remitted to the supplier was a financial responsibility of the Company. The Company accounted for the gain or loss related to the payment of these transactions as part of other income or expense. The Company has renegotiated its supply agreement with this foundry to purchase wafers in U.S. currency, see below for our revised supply agreement.

Two of our major suppliers have wafer supply agreements based in U.S. dollars; however, our agreements with these foundries also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these 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.

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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 Integration 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 has filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company has filed a cross-appeal seeking to increase the damages award. Briefing on the appeal is now complete, and a hearing is expected in the coming months.

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



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NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 ("SG") 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. Trial is currently scheduled to begin in April 2012.

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

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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 issued a first claim construction order regarding the Company's asserted patents on July 13, 2011 and a second claim construction order regarding Fairchild's asserted patent on August 30, 2011. Discovery is currently under way.

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 proceedings are still in their early stages, with no hearings or trial currently scheduled. The suits assert four Chinese patents and seek an injunction and damages of approximately \$17.0 million. Power Integrations Netherlands has 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 and rulings expected in the coming months. The Company believes the Fairchild and SG claims discussed above are without merit and intends 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.

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.

In the quarter ended March 31, 2011, the IRS informed the Company that the IRS intends to propose adjustments to the Company's taxable income for the years 2003 through 2006 related to the Company's intercompany research and development cost-sharing arrangement and related issues (refer to Note 9 for further details). The Company believes that the IRS position is without merit and intends to defend its tax return position vigorously.

While there can be no assurances as to the ultimate outcome of any litigation involving the Company, management does not believe any such pending legal proceeding or claim will result in a judgment or settlement that would have a material adverse effect on the Company's financial position, results of operations or cash flows.

13. RECENT ACCOUNTING PRONOUNCEMENTS:

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, Fair Value Measurement, ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The Company will apply these amendments prospectively beginning in the first quarter of fiscal 2012. The Company is currently evaluating the impact the application of these amendments will have on its consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (ASC Topic 220). This amendment gives an entity two options to present the total of comprehensive income, the components of net income, and the components of other comprehensive income. An entity can elect to present comprehensive income in either (1) a single continuous statement of

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comprehensive income, or (2) in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The Company will apply this amendment beginning in the first quarter of 2012. The Company is currently evaluating the impact the application of this amendment will have on its condensed consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment, (ASC Topic 350). Under the amendments in this ASU, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity also has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted.

On January 1, 2011, the Company adopted the following accounting pronouncements:

In December 2010, FASB issued ASU No. 2010-29, Business Combinations (ASC Topic 805). The amendments in this update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also improve the usefulness of the pro forma revenue and earnings disclosures by requiring a description of the nature and amount of material, nonrecurring pro forma adjustments that are directly attributable to the business combination(s). The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on the Company's condensed consolidated financial statements.

In December 2010, FASB issued ASU No. 2010-28, Intangibles - Goodwill and Other (ASC Topic 350). Under Topic 350 on goodwill and other intangible assets, testing for goodwill impairment is a two-step test. When a goodwill impairment test is performed (either on an annual or interim basis), an entity must assess whether the carrying amount of a reporting unit exceeds its fair value (Step 1). If it does, an entity must perform an additional test to determine whether goodwill has been impaired and to calculate the amount of that impairment (Step 2). The amendments in this update modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors require that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on the Company's condensed consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update (“ASU”) No. 2010-06, “Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Instruments.” ASU No. 2010-06 amends ASC 820 to require additional disclosures regarding fair value measurements. Specifically, the ASU requires entities to disclose the amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy, to disclose reasons for any transfers in or out of Level 3 and to separately disclose information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements. In addition, the ASU also amends ASC 820 to clarify certain existing disclosure requirements. Except for the requirement to disclose information about purchases, sales, issuances and settlements in the reconciliation of recurring Level 3 measurements separately, the amendments to ASC 820 made by ASU No. 2010-06 were effective for the Company's 2010 interim and annual reporting periods. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements is effective for the Company's 2011 interim and annual reporting

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

periods. The adoption of these provisions did not have a material impact on the Company's consolidated financial statements.

## 14. ACQUISITIONS:

On February 26, 2010, the Company entered into a definitive agreement to purchase the assets of an early-stage research and development company involved in developing certain technology that is consistent with the Company's long-term business strategy, for cash totaling \$11.5 million. The Company accounted for the transaction as an acquisition of a business and completed the acquisition on August 26, 2010. The Company allocated \$6.2 million of the purchase price to goodwill, which is deductible for tax purposes, \$4.7 million to in-process research and development, which the Company will amortize over the estimated life of the technology upon completion of its development (the Company does not expect to amortize in-process research and development within the current year), and \$0.6 million to fixed assets. The Company also expensed \$0.4 million of acquisition-related costs which were recorded as general and administrative expense in 2010. Goodwill recognized in the acquisition was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce.

On December 31, 2010, the Company acquired certain assets of Qspeed Semiconductor for approximately \$7.0 million in cash. The Company accounted for the transaction as an acquisition of a business.

The Company's acquisition of Qspeed effectively settled a preexisting license agreement under which the Company had paid Qspeed a prepaid royalty of \$5.25 million in exchange for the use of its technology. Because the terms of the license agreement were determined to represent fair value at the acquisition date, the Company did not record any gain or loss separately from the acquisition and the \$5.25 million unamortized prepaid royalty was included as part of the acquisition-date fair value of consideration transferred.

Fair value consideration consists of the following (in thousands):

|                                       |           |
|---------------------------------------|-----------|
| Cash                                  | \$ 6,955  |
| Settlement of preexisting arrangement | 5,250     |
| Total                                 | \$ 12,205 |

Of the total consideration transferred, \$6.8 million was allocated to goodwill, which is deductible for tax purposes, \$1.8 million was allocated to developed technology, \$0.9 million was allocated to customer relationships, \$0.4 million was allocated to fixed assets, \$2.1 million was allocated to inventory, including \$0.6 million of inventory markup, which will be amortized to cost of revenues, and \$0.2 million was allocated to accounts receivable. Goodwill recognized in the acquisition of Qspeed Semiconductor was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce.

## 15. INVESTMENT IN THIRD PARTY:

On October 22, 2010, the Company made a \$7.0 million investment in preferred stock of a privately held company, SemiSouth Laboratories ("SemiSouth"). Also in October 2010, the Company paid \$10.0 million as a prepaid royalty in exchange for the right to use SemiSouth's technology. The Company will amortize the royalty to cost of revenues based on the Company's sales of products incorporating the licensed technology. The Company classified its investment, with a carrying value of \$7.0 million, and prepaid royalty of \$10.0 million within Other Assets in the Company's condensed consolidated balance sheet as of September 30, 2011. The Company does not expect to

amortize the prepaid royalty in 2011.

In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the term of the agreement, SemiSouth can borrow up to \$8.6 million through January 2013. As of September 30, 2011, a total of \$8.0 million had been funded, comprised of; \$3.9 million funded, less payments withheld under this lease arrangement to finance capital equipment commencing in February 2011, and \$4.1 million paid as deposits on equipment which the Company will lease to SemiSouth upon delivery of such equipment, refer to Note 17, Lease Line to Third Party, for details. The Company included the lease line receivable and deposits on equipment in Other Assets and Prepaid Expenses and Other Current Assets in its condensed consolidated balance sheet at September 30, 2011.

The Company has determined that its investment in SemiSouth, in which the Company holds less than 20% equity interest, is a variable interest entity (“VIE”) in which the Company is not the primary beneficiary. The primary factors in the

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company's assessment were; (i) SemiSouth's management team and board of directors were solely responsible for all business and financial decisions for SemiSouth and (ii) the Company does not have the ability through this VIE to direct the activities that significantly impact the economic performance of SemiSouth. The Company accounts for its non-marketable investment in SemiSouth under the cost method.

The Company's maximum exposure to loss as a result of its interest in SemiSouth is limited to the aggregate of the carrying value of our equity investment, and up to \$8.6 million for the lease line agreement. There were no additional future funding commitments to SemiSouth as of September 30, 2011.

The Company's investment in SemiSouth is periodically reviewed for other-than-temporary declines in fair value by considering available evidence, including general market conditions, SemiSouth's financial condition, pricing in recent rounds of financing, earnings and cash flow forecasts, recent operational performance and any other readily available market data.

The Company's 2010 agreement with SemiSouth provides, among other things, that the Company has the option to acquire SemiSouth in the future ("Call Option") and that the Company may be obligated to acquire SemiSouth at a future date if SemiSouth achieves certain financial performance conditions ("Put Option"). The Put and Call Options terminate on the date that is approximately a month following delivery to the Company of SemiSouth's financial statements for the quarter ending June 30, 2013.

The Call Option can be exercised by the Company at a multiple of SemiSouth's annualized net operating profits after tax ("NOPAT") (based on the average of such measures during certain months), as defined in the agreement. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth. The minimum acquisition price would be \$36 million.

The Put Option can only be exercised by SemiSouth once certain revenue and profit metrics have been reached. At that time, SemiSouth could obligate the Company to acquire SemiSouth at a multiple of SemiSouth's NOPAT. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth. In order to reach the revenue and profit metrics required to exercise the Put Option, SemiSouth would need to increase its quarterly revenue to approximately 27 times the level of revenues in the third quarter of 2011.

The NOPAT multiple was determined to reflect fair value based on the Market Approach using Level 2 inputs that are derived principally from observable market data by comparing multiples for similar publicly traded companies. Due to the fact that the strike price of the Call Option and Put Option is continually being adjusted to reflect the changes in the fair value of SemiSouth, neither the Put Option nor the Call Option are expected to have value. Based on these factors, the fair value of the Put/Call Option was determined to be zero.

In July 2011, SemiSouth obtained \$15 million of additional financing through the sale, and concurrent licensing back, of its intellectual property ("IP") with a financing company. In connection with this arrangement, the Company entered into a contingent purchase commitment with the financing company for SemiSouth's IP. The contingent purchase commitment requires the Company to purchase the IP previously owned by SemiSouth from its new owner for \$15 million (plus reimbursement of certain expenses) under certain conditions generally relating to SemiSouth's failure to make certain payments or SemiSouth's insolvency. In this event, the agreement sets forth a process to be followed before the Company's purchase commitment matures. First, the agreement allows the Company to exercise its Call Option for a certain period of time and under certain conditions. If the Company does not initially exercise its Call Option, then SemiSouth can be sold to a third party during a period of time of up to approximately half a year (which period of time may be shortened by the new SemiSouth IP owner) or the Company could still exercise its Call Option. After that period of time elapses, the Company is obligated to purchase the SemiSouth IP for \$15 million

(plus reimbursement of certain expenses). The Company provided a \$15 million letter of credit in August 2011 to the financing company to secure the contingent purchase commitment.

In addition, the Company entered into a contract in July 2011 with SemiSouth to act as a sales representative for SemiSouth. The sales representation agreement will allow the Company to earn a fee for its efforts in representing, promoting and soliciting orders for SemiSouth products. The contract can be terminated with or without cause by giving prior written notice to the other party.

16. SUPPLIER AGREEMENT:

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POWER INTEGRATIONS, INC.

NOTES TO (Unaudited) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company entered into a wafer supply agreement amendment with one of its foundries in the third quarter of 2008, which amended its previous agreement with the foundry. The amended agreement includes a Company prepayment of \$3.1 million for raw materials. Purchases of raw materials under this agreement were made based upon production build plans of the Company's wafers. As of December 31, 2010, \$0.9 million remained prepaid under this agreement, and in the six months ended June 30, 2011, this prepayment was fully amortized. The Company included the prepayment in prepaid expenses and other current assets in its December 31, 2010, condensed consolidated balance sheet.

**17. LEASE LINE TO THIRD PARTY:**

In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the term of the agreement, SemiSouth can borrow up to \$8.6 million through January 2013 (reduced from \$15.5 million at March 31, 2011). As of September 30, 2011, a total of \$8.0 million had been funded, comprised of; \$3.9 million funded, less payments withheld under this lease arrangement to finance capital equipment commencing in February 2011, and \$4.1 million paid as deposits on equipment which the Company will lease to SemiSouth upon delivery of such equipment. The Company included the lease line receivable and deposits on equipment in Other Assets and Prepaid Expenses and Other Current Assets in its condensed consolidated balance sheet at September 30, 2011. The total lease payments related to the \$3.9 million funded, including interest, will be received over a four-to-eight year term and are reflected in the table below (in millions):

| Fiscal Year               | Total Minimum Lease Payments |
|---------------------------|------------------------------|
| 2011 (remaining 3 months) | \$0.1                        |
| 2012                      | 0.6                          |
| 2013                      | 0.6                          |
| 2014                      | 0.6                          |
| 2015                      | 0.6                          |
| Thereafter                | 1.7                          |
| Total                     | \$4.2                        |

The Company assessed the credit worthiness of SemiSouth at the inception of the lease line, and is monitoring their credit quality on an ongoing basis. If the credit worthiness of SemiSouth diminishes the Company will establish a specific reserve against the lease line receivable at that time.

**18. BANK LINE OF CREDIT:**

In February 2011, the Company entered into an unsecured credit agreement with a bank (the "Credit Agreement"). Pursuant to the Credit Agreement, the Company can request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. The agreement also covers advances for commercial letters of credit. At September 30, 2011, the Company had a \$15.0 million outstanding letter of credit in connection with an existing contingent purchase commitment (refer to Note 15, Investment in Third Party, for further details). The terms of this credit agreement require the Company to remain in compliance with certain financial and other covenants, which the Company is currently in compliance with.

**19. SUBSEQUENT EVENTS:**

In November 2011, the board of directors authorized the use of \$30.0 million for the repurchase of the Company's common stock. Any repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors. There is no expiration date for this repurchase program.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, the Consolidated Financial Statements and Notes thereto for the year ended December 31, 2010, included in our Annual Report on Form 10-K/A, filed with the Securities and Exchange Commission on June 15, 2011, and with management's discussion and analysis of our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 25, 2011. This discussion contains forward-looking statements, including our financial outlook, that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A—"Risk Factors" and elsewhere in this report.

Overview

We design, develop, manufacture and market high-voltage, analog and mixed-signal integrated circuits ("ICs") and high-voltage diodes for use in electronic power supplies, also known as switched-mode power supplies. Our ICs and diodes are used principally in AC-DC power supplies in a wide variety of end products, primarily in the consumer, communications, computer and industrial electronics markets. For example, our ICs are commonly used in such end products as mobile-phone chargers, desktop computers, home entertainment equipment, appliances, utility meters and LED light bulbs and fixtures.

We believe that our products enable power supplies that are superior to those designed with alternative technologies. We differentiate our ICs through innovation aimed at helping our customers meet the desired performance specifications for their power supplies, including increasingly stringent energy-efficiency requirements, while minimizing complexity, component count, time-to-market and overall system cost. We invest significant resources in research and development in an effort to achieve this differentiation.

While the size of the power-supply market fluctuates with changes in macroeconomic conditions, the market has generally exhibited a modest growth rate over time as growth in the unit volumes of power supplies has largely been offset by reductions in the average selling price of components in this market. Therefore, the growth of our business depends primarily on our penetration of the power supply market, and our success in expanding the addressable market by introducing new products that address a wider range of applications. Our growth strategy includes the following elements:

Increase the penetration of our ICs in the "low-power" AC-DC power supply market. The vast majority of our revenues come from power-supply applications requiring 50 watts of output or less. We continue to introduce more advanced products that make our IC-based solutions more attractive in this market. We have also increased the size of our sales and field-engineering staff considerably in recent years, and we continue to expand our offerings of technical documentation and design-support tools and services in order to help customers use our ICs. These tools and services include our PI Expert™ design software, which we offer free of charge, and our transformer-sample service.

Capitalize on the growing demand for more energy-efficient electronic products and lighting technologies. We believe that energy-efficiency is becoming an increasingly important design criterion for power supplies due largely to the emergence of standards and specifications that encourage, and in some cases mandate, the design of more energy-efficient electronic products. While power supplies built with competing technologies are often unable to meet these standards cost-effectively, power supplies incorporating our ICs are generally able to comply with all known efficiency specifications currently in effect.

Additionally, technological advances combined with regulatory and legislative actions are resulting in the adoption of alternative lighting technologies such as light-emitting diodes, or LED. We believe this presents a significant opportunity for us because our ICs are used in power-supply (or “driver”) circuitry for high-voltage LED lighting applications.

Increase the penetration of our products in “high-power” applications. We believe we have developed and acquired new technologies and products that enable us to bring the benefits of highly integrated power supplies to applications requiring more than 50 watts of output. These include such applications as main power supplies for flat-panel TVs and desktop PCs, as well as power supplies for LED streetlights, game consoles, and notebook computers, among others.

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Our quarterly operating results are difficult to predict and subject to significant fluctuations. We plan our production and inventory levels based on internal forecasts of projected customer demand, which is highly unpredictable and can fluctuate substantially. Customers typically may cancel or reschedule orders on short notice without significant penalty and, conversely, often place orders with very short lead times to delivery. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile. For example, our revenues decreased 6% in the three months ended September 30, 2011 compared with the prior quarter, and we expect a further decrease in the subsequent quarter; we believe the downturn in revenues is primarily the result of global macroeconomic factors.

Our net revenues were \$75.1 million and \$232.0 million in the three and nine months ended September 30, 2011, respectively, compared to \$75.5 million and \$226.8 million in the same periods of 2010. The slight decrease for the three-month period was driven primarily by lower sales of our products into the communications end market, where our products are primarily used in cell-phone chargers. The decline was partially offset by increased sales into the consumer, industrial and computer end markets. The increase for the nine-month period was driven primarily by increased sales into the industrial and computer end markets, partially offset by slightly lower sales into the communications end market.

Our top ten customers, including distributors that resell our products to OEMs and merchant power supply manufacturers, accounted for 65% of our net revenues in both the three and nine months ended September 30, 2011, compared to 64% of our net revenues in both the three and nine months ended September 30, 2010. Our top two customers, both distributors of our products, collectively accounted for approximately 31% of our net revenues in both the three and nine months ended September 30, 2011. In 2010, our top two customers, both distributors of our products, collectively accounted for approximately 29% and 27% of our net revenues, in the three- and nine-month periods ended September 30, 2011, respectively. International sales comprised 96% of our net revenues in both the three and nine months ended September 30, 2011, and 94% and 95% in the three and nine months ended September 30, 2010, respectively.

Because our industry is intensely price-sensitive, our gross margin (gross profit divided by net revenues) is subject to change based on the relative pricing of solutions that compete with ours. Variations in product and customer mix can also cause our gross margin to fluctuate. Also, because we purchase a large percentage of our silicon wafers from foundries located in Japan, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. Changes in the prices of raw materials used in our products, such as certain metals, can also affect our gross margin. Although our wafer-fabrication and assembly operations are outsourced, as are most of our test operations, a portion of our production costs are fixed in nature. As a result, our unit costs and gross profit margin are impacted by the volume of units we produce.

Our gross profit margin was 47% of net revenues in the three and nine months ended September 30, 2011, compared with 52% of net revenues and 51% of net revenues, respectively, in the three and nine months ended September 30, 2010. The decrease was due primarily to higher input costs as well as a less favorable product mix; the increase in input costs was driven primarily by the decline in the value of the U.S. dollar versus the Japanese yen, which has increased the cost of silicon wafers purchased from our Japanese wafer fabrication foundries, as well as the rise in the prices of certain materials, primarily gold and copper, used in the assembly of our products. While we cannot necessarily predict the future direction of our gross margin because many of the factors influencing it are outside of our control, we expect our gross margin to improve in the fourth quarter of this year as a result of product-cost improvements, primarily driven by silicon cost reductions.

Total operating expenses in the three and nine months ended September 30, 2011 were \$24.5 million and \$73.7 million, respectively, and \$23.8 million and \$67.5 million in the same periods in 2010, respectively. The increase in both the three and nine months ended September 30, 2011, compared with the same periods in the prior year, was

driven primarily by increased payroll and related expenses due to increased headcount, including higher research and development headcount resulting from an acquisition we completed in the third quarter of 2010 and increases in sales and marketing headcount as a result of growth in our sales force. These increases were partially offset by decreased stock-based compensation expense, lower acquisition-related expenses (we acquired two businesses in 2010, refer to Note 14, Acquisitions, in our Notes to Condensed Consolidated Financial Statements, for details) and reduced legal expenses related to patent litigation (refer to Note 12, Legal Proceedings and Contingencies, in our Notes to Condensed Consolidated Financial Statements for recent activity).

#### Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ("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. On an ongoing basis, we evaluate our estimates, including those listed below. We base our estimates on historical facts and various other assumptions that we believe to be reasonable at the time the estimates are made. Actual results could differ from those estimates.



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Our critical accounting policies are as follows:

- revenue recognition;
- stock-based compensation;
- estimating distributor pricing credits;
- estimating write-downs for excess and obsolete inventory;
- income taxes; and
- goodwill and intangible assets.

Our critical accounting policies are important to the portrayal of our financial condition and results of operations, and require us to make judgments and estimates about matters that are inherently uncertain. A brief description of these critical accounting policies is set forth below. For more information regarding our accounting policies, see Note 2, Summary of Significant Accounting Policies, in our Notes to Condensed Consolidated Financial Statements.

### Revenue recognition

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Shipping terms to international OEM customers and merchant power supply manufacturers from our facility in California are “delivered at frontier” (“DAF”), under which title to the product passes to the customer and revenue is recognized when the shipment reaches the destination country. Shipping terms to international OEMs and merchant power supply manufacturers on shipments from our facility outside of the United States are “EX Works” (EXW), meaning that title to the product transfers to the customer upon shipment from our foreign warehouse. Shipments to OEMs and merchant power supply manufacturers in the Americas are “free on board” (“FOB”) point of origin 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 as described below.

We apply the provisions of ASC 605-10 (formerly Staff Accounting Bulletin No. 104, Revenue Recognition) and all related appropriate guidance. We recognize revenue 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. We generally use customer purchase orders to determine the existence of an arrangement. We consider delivery to have occurred when title and risk of loss have transferred to the customer. We consider the price to be fixed based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based on the creditworthiness of the customer as determined by credit checks we perform as well as the customer's payment history.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method. Sales to distributors are made under terms allowing certain price protection and rights of return on our products held by the distributors. As a result of these rights, we defer the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell our products to their end customers. We determine the amount to defer based on the level of actual inventory on hand at our distributors as well as inventory in transit to our distributors. Fluctuations in deferred income on sales to distributors coincide with an increase or decrease in revenue shipments to our distributors; in addition, deferred income levels are also impacted by the speed at which our distributors sell our products to their end customers. 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 September 30, 2011 and December 31, 2010 was approximately \$22.1 million and \$24.7 million, respectively. The total deferred cost as of September 30, 2011 and December 31, 2010 was approximately \$11.8 million and \$12.5 million, respectively.

### Stock-based compensation

We apply the provisions of ASC 718-10, Share-Based Payment. Under the provisions of ASC 718-10, we recognize 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. We use 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 cost to recognize. Changes in these estimates could result in changes to our compensation charges.

### Estimating distributor pricing credits

Historically, approximately two-thirds of our total sales have been made through distributors. Frequently, distributors need a cost lower than our standard sales price in order to win business. After the distributor ships product to its customer, the

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distributor submits a “ship and debit” claim to us in order to adjust its cost from the standard price to the approved lower price. After verification by us, a credit memo is issued to the distributor to adjust the sell-in price from the standard distribution price to the pre-approved lower price. We maintain a reserve for these credits that appears as a reduction to accounts receivable in our consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in our current and/or future net revenues. To establish the adequacy of our reserves, we analyze historical ship and debit amounts and levels of inventory in the distributor channels. If our reserves are not adequate, our net revenues could be adversely affected.

### Estimating write-downs for excess and obsolete inventory

When evaluating the adequacy of our valuation adjustments for excess and obsolete inventory, we identify excess and obsolete products and also analyze historical usage, forecasted production based on demand forecasts, current economic trends and historical write-offs. This write-down is reflected as a reduction to inventory in the consolidated balance sheets and an increase in cost of revenues. If actual market conditions are less favorable than our assumptions, we may be required to take additional write-downs, which could adversely impact our cost of revenues and operating results.

### Income taxes

Income tax expense is an estimate of current income taxes payable or refundable in the current fiscal year based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences and carry-forwards that are recognized for financial reporting and income tax purposes.

We account for income taxes under the provisions of ASC 740 (formerly SFAS No. 109, Accounting for Income Taxes). 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. We recognize valuation allowances to reduce any deferred tax assets to the amount that we estimate will more likely than not be realized based on available evidence and management’s judgment. We limit the deferred tax assets recognized related to certain of our officers’ compensation to amounts that we estimate will be deductible in future periods based upon Internal Revenue Code Section 162(m). In the event that we determine, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, we 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 our expectations could have a material impact on our results of operations and financial position.

As of September 30, 2011, we continue to maintain a valuation allowance on a portion of our California deferred tax assets as we believe that it is not more likely than not that the deferred tax assets will be fully realized. We also maintain a valuation allowance with respect to certain of our deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

In the first quarter of 2011, the IRS informed us that it intends to propose adjustments to our taxable income for fiscal years 2003 thru 2006 related to our intercompany research and development cost-sharing arrangement and related issues. We believe the IRS's position with respect to the proposed adjustment is inconsistent with applicable tax law, and that we have a meritorious defense to our position. Accordingly, we intend to continue to challenge the IRS's position on this matter vigorously. While we believe the IRS's asserted position on this matter is not supported by applicable law, we have provided reserves for our position in this matter, and we may be required to make payments to the IRS pending resolution of this matter. If this matter is litigated and the IRS is able to successfully sustain its

position, our results of operations and financial condition could be materially and adversely affected (refer to Note 9, in our Notes to Condensed Consolidated Financial Statements for further details). Resolution of this matter is not anticipated within the next year.

#### Goodwill and intangible assets

In accordance with ASC 350-10, Goodwill and Other Intangible Assets, we evaluate goodwill for impairment on an annual basis, or as other indicators of impairment emerge. The provisions of ASC 350-10 require that we perform a two-step impairment test. In the first step, we compare the implied fair value of our single reporting unit to its carrying value, including goodwill. If the fair value of our reporting unit exceeds the carrying amount no impairment adjustment is required. If the carrying amount of our reporting unit exceeds the fair value, step two will be completed to measure the amount of goodwill impairment loss, if any exists. If the carrying value of our single reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference, but not in excess of the carrying amount of the goodwill. We evaluated

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goodwill for impairment in the fourth quarter 2010, and concluded that no impairment existed as of December 31, 2010. Additionally, no impairment indicators have been identified during the nine months ended September 30, 2011.

ASC 350-10 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives, and reviewed for impairment in accordance with ASC 360-10, Accounting for the Impairment or Disposal of Long-Lived Assets. We review long-lived assets, such as acquired intangibles and property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We measure recoverability of assets to be held and used by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, we recognize an impairment charge by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

## Results of Operations

The following table sets forth certain operating data as a percentage of net revenues for the periods indicated.

|  | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |   |
|--|-------------------------------------|---------|------------------------------------|---------|---|
|  | 2011                                | 2010    | 2011                               | 2010    |   |
| Net revenues                             | 100.0                               | % 100.0 | % 100.0                            | % 100.0 | % |
| Cost of revenues                         | 53.3                                | 48.3    | 53.0                               | 48.7    |   |
| Gross profit                             | 46.7                                | 51.7    | 47.0                               | 51.3    |   |
| Operating expenses:                      |                                     |         |                                    |         |   |
| Research and development                 | 13.8                                | 12.5    | 13.2                               | 11.5    |   |
| Sales and marketing                      | 10.6                                | 10.2    | 10.5                               | 9.7     |   |
| General and administrative               | 8.2                                 | 8.9     | 8.1                                | 8.5     |   |
| Total operating expenses                 | 32.6                                | 31.6    | 31.8                               | 29.7    |   |
| Income from operations                   | 14.1                                | 20.1    | 15.3                               | 21.6    |   |
| Other income, net                        | 0.7                                 | 0.6     | 0.6                                | 0.6     |   |
| Income before provision for income taxes | 14.8                                | 20.7    | 15.9                               | 22.2    |   |
| Provision for income taxes               | 4.8                                 | 4.0     | 3.8                                | 4.3     |   |
| Net income                               | 10.0                                | % 16.7  | % 12.1                             | % 17.9  | % |

## Comparison of the Three Months and Nine Months Ended September 30, 2011 and 2010

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three months ended September 30, 2011 were \$75.1 million compared with \$75.5 million for the three months ended September 30, 2010, a decrease of approximately 1%. The slight decrease in revenues was driven primarily by lower shipments of our products into the communications end market, where our products are primarily used in cellphone chargers. The decline was partially offset by increased product shipments into the consumer, industrial and computer end markets.

Net revenues for the nine months ended September 30, 2011 were \$232.0 million compared with \$226.8 million for the comparable period of 2010, an increase of approximately 2.3%. The increase was driven primarily by increased shipments into the industrial end market (primarily LinkSwitch products) and computer end market, partially offset by slightly lower shipments (primarily TinySwitch products) into the communications market.

Our net revenue mix by product family and by end market for the three and nine months ended September 30, 2011 compared to the three and nine months ended September 30, 2010 were as follows:

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| Product Family | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |   |
|----------------|-------------------------------------|------|------------------------------------|------|---|
|                | 2011                                | 2010 | 2011                               | 2010 |   |
| LinkSwitch     | 43                                  | % 39 | % 42                               | % 37 | % |
| TinySwitch     | 33                                  | % 37 | % 33                               | % 38 | % |
| TOPSwitch      | 21                                  | % 23 | % 23                               | % 24 | % |
| Other          | 3                                   | % 1  | % 2                                | % 1  | % |

| End Market     | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |   |
|----------------|-------------------------------------|------|------------------------------------|------|---|
|                | 2011                                | 2010 | 2011                               | 2010 |   |
| Consumer       | 39                                  | % 37 | % 37                               | % 38 | % |
| Communications | 26                                  | % 30 | % 29                               | % 30 | % |
| Industrial     | 23                                  | % 22 | % 22                               | % 20 | % |
| Computer       | 12                                  | % 11 | % 12                               | % 12 | % |

International sales, comprised of sales outside of the Americas based on “ship to” customer locations, were \$71.9 million, or 96% of net revenues in the third quarter of 2011, compared to \$71.2 million, or 94% of net revenues, for the same period in 2010. International sales were \$221.8 million, or 96% of net revenues, for the nine months ended September 30, 2011, compared to \$214.5 million, or 95% of net revenues, for the same period in 2010. Although the power supplies using our products are distributed to end markets worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region were 84% of our net revenues for both the three and nine months ended September 30, 2011, and 83% of our net revenues in both the three and nine months ended September 30, 2010. We expect international sales, and sales to the Asia region in particular, to continue to account for a large portion of our net revenues in the future.

Sales through distributors accounted for 72% and 70% of net revenues in the three and nine months ended September 30, 2011, respectively, with direct sales to OEMs and power supply manufactures accounting for the remainder. For the three and nine months ended September 30, 2010, distributors accounted for 67% and 68% of net revenues, respectively, while direct sales accounted for the remainder.

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

| Customer | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|----------|-------------------------------------|------|------------------------------------|------|
|          | 2011                                | 2010 | 2011                               | 2010 |
| A        | 19%                                 | 18%  | 19%                                | 16%  |
| B        | 12%                                 | 11%  | 12%                                | 11%  |

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

Gross profit. Gross profit is net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our contracted foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facility, and overhead associated with the management of our supply chain. Gross margin is gross profit divided by net revenues. The table below compares gross profit and gross margin for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|  | Three Months Ended<br>September 30, | Nine Months Ended<br>September 30, |
|--|-------------------------------------|------------------------------------|
|--|-------------------------------------|------------------------------------|

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|              | 2011   | 2010   | 2011    | 2010    |
|--------------|--------|--------|---------|---------|
| Net revenues | \$75.1 | \$75.5 | \$232.0 | \$226.8 |
| Gross profit | \$35.0 | \$39.0 | \$109.1 | \$116.4 |
| Gross margin | 46.7%  | 51.7%  | 47.0%   | 51.3%   |

The decrease in gross margin for the three and nine months ended September 30, 2011, compared with the same periods in the prior year, was due primarily to higher input costs and a less favorable product mix. The increase in input costs



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was driven primarily by the decline in the value of the U.S. dollar versus the Japanese yen, which has increased the cost of silicon wafers purchased from our Japanese wafer fabrication foundries, as well as the rise in the prices of certain materials, primarily gold and copper, used in the assembly of our products.

Research and development expenses. Research and development, or R&D, expenses consist primarily of employee-related expenses including stock-based compensation and expensed material and facility costs associated with the development of new processes and new products. We also record R&D expenses for prototype wafers related to new products until such products are released to production. The table below compares R&D expenses for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|                                    | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|------------------------------------|-------------------------------------|--------|------------------------------------|---------|
|                                    | 2011                                | 2010   | 2011                               | 2010    |
| Net revenues                       | \$75.1                              | \$75.5 | \$232.0                            | \$226.8 |
| R&D expenses                       | \$10.3                              | \$9.3  | \$30.6                             | \$26.1  |
| R&D expenses as a % of net revenue | 13.8%                               | 12.5%  | 13.2%                              | 11.5%   |

R&D expenses increased in the three and nine months ended September 30, 2011 compared to the same periods in 2010, driven primarily by increased payroll and related expenses, resulting from increased headcount, which in turn was due to an acquisition completed in August of 2010. This acquisition also resulted in increased depreciation and facilities expenses (See Note 14, Acquisitions, in our Notes to Condensed Consolidated Financial Statements, for details). Product-development and materials expenses also increased year-over-year for both the three- and nine-month periods ended September 30, 2011, due to expenses related to foundry qualifications and ongoing new-product development, which we expect to incur at approximately the same rate in the fourth quarter of 2011. These increases were partially offset by lower stock-based compensation expense reflecting our expectation that the established 2011 performance targets for vesting of our 2011 performance-based awards are unlikely to be met. Stock-based compensation expenses for the three-month period were further reduced by the reversal of expenses accrued in the first two quarters of 2011.

Sales and marketing expenses. Sales and marketing expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, and facilities expenses, including expenses associated with our regional sales and support offices. The table below compares sales and marketing expenses for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|--------|------------------------------------|---------|
|  | 2011                                | 2010   | 2011                               | 2010    |
| Net revenues                                       | \$75.1                              | \$75.5 | \$232.0                            | \$226.8 |
| Sales and marketing expenses                       | \$8.0                               | \$7.7  | \$24.3                             | \$22.1  |
| Sales and marketing expenses as a % of net revenue | 10.6%                               | 10.2%  | 10.5%                              | 9.7%    |

The increase in sales and marketing expenses in the three and nine months ended September 30, 2011 compared to the same periods of 2010 was driven primarily by increased payroll and related expenses and travel and sales infrastructure expenses as a result of increased headcount to expand our international sales force. The increases were partially offset by lower stock-based compensation expense as described above.

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General and administrative expenses. General and administrative, or G&A, expenses consist primarily of employee-related expenses, including stock-based compensation expenses for administration, finance, human resources and general management, as well as consulting, professional services, legal and auditing expenses. The table below compares G&A expenses for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|                                    | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|------------------------------------|-------------------------------------|--------|------------------------------------|---------|
|                                    | 2011                                | 2010   | 2011                               | 2010    |
| Net revenues                       | \$75.1                              | \$75.5 | \$232.0                            | \$226.8 |
| G&A expenses                       | \$6.1                               | \$6.7  | \$18.8                             | \$19.2  |
| G&A expenses as a % of net revenue | 8.2%                                | 8.9%   | 8.1%                               | 8.5%    |

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G&A expenses decreased in the three and nine months ended September 30, 2011 compared to the prior year. The decreases were due primarily to: (1) reduced stock-based compensation expense for the same reasons as described above for R&D expense, (2) reduced acquisition-related expenses in the current year (we acquired two businesses in 2010, refer to Note 14, Acquisitions, in our Notes to Condensed Consolidated Financial Statements, for details), and (3) reduced legal expenses related to patent litigation (refer to Note 12, Legal Proceedings and Contingencies, in our Notes to Condensed Consolidated Financial Statements for recent activity). These decreases were partially offset by increased salaries and related expenses resulting from increased headcount to support our overall growth.

Other income, net. Other income, net consists primarily of interest income earned on cash and cash equivalents and short and long-term investments. The table below compares other income, net for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|                                    | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|------------------------------------|-------------------------------------|--------|------------------------------------|---------|
|                                    | 2011                                | 2010   | 2011                               | 2010    |
| Net revenues                       | \$75.1                              | \$75.5 | \$232.0                            | \$226.8 |
| Other income                       | \$0.6                               | \$0.4  | \$1.5                              | \$1.4   |
| Other income as a % of net revenue | 0.7%                                | 0.6%   | 0.6%                               | 0.6%    |

Other income, net, increased slightly in the three and nine months ended September 30, 2011, compared to the same periods in 2010. The increases were related to interest earned on our lease line to SemiSouth, refer to Note 17, Lease Line to Third Party, in our Notes to Condensed Consolidated Financial Statements, for details.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes.

The table below compares income tax expenses for the three and nine months ended September 30, 2011 and 2010 (dollars in millions):

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2011                                | 2010   | 2011                               | 2010   |
| Income before provision for income taxes | \$11.1                              | \$15.7 | \$36.9                             | \$50.3 |
| Provision for income taxes               | \$3.6                               | \$3.0  | \$8.9                              | \$9.8  |
| Effective tax rate                       | 32.4%                               | 19.4%  | 24.2%                              | 19.5%  |

The difference between the expected statutory rate of 35% and our effective tax rate for the three and nine months ended September 30, 2011, was primarily due to the beneficial impact of the geographic distribution of our world-wide earnings and the beneficial impact of a research and experimentation tax credit. The difference between the expected statutory rate of 35% and our effective tax rate for the three and nine months ended September 30, 2010, was primarily due to the beneficial impact of the geographic distribution of our world-wide earnings.

### Liquidity and Capital Resources

As of September 30, 2011, we had \$222.5 million in cash, cash equivalents and short-term and long-term investments, an increase of approximately \$7.7 million from \$214.8 million as of December 31, 2010. As of September 30, 2011, we had working capital, defined as current assets less current liabilities, of \$229.6 million, an increase of approximately \$17.5 million from \$212.1 million as of December 31, 2010.

In February 2011, we entered into an unsecured credit agreement with a bank (the "Credit Agreement"). Pursuant to the Credit Agreement, we can request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. The agreement also covers advances for commercial letters of credit.

We currently have an outstanding letter of credit in the amount of \$15.0 million in connection with our contingent purchase commitment for SemiSouth's intellectual property (see Note 15, Investment in Third Party, in our Notes to Condensed Consolidated Financial Statements for details). The terms of the credit agreement require us to remain in compliance with certain covenants including maintenance of specified levels of liquidity and tangible net worth; we are currently in compliance with these covenants.

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Operating activities generated cash of \$60.0 million in the nine months ended September 30, 2011. Our net income for this period was \$28.0 million; we also incurred non-cash depreciation, amortization and stock-based compensation expenses of \$11.3 million, \$0.7 million and \$6.6 million, respectively. Additional sources of cash included (i) a \$10.2 million decline in inventory due to reduced wafer purchases, (ii) a \$4.9 million increase in accrued liabilities resulting primarily from an increase in our long-term tax liability and (iii) a \$2.8 million decrease in prepaid legal fees and prepaid inventory amortization. These sources of cash were partially offset by (i) a \$4.5 million increase in accounts receivable due to higher shipments at the end of September compared to December and the timing of sales rebate payments in the fourth quarter of 2010 versus the third quarter of 2011 and (ii) a \$1.9 million decrease in deferred income on sales to distributors resulting from decreased inventory levels at our distributors.

Operating activities generated cash of \$65.6 million in the nine months ended September 30, 2010. Our net income for this period was \$40.5 million; we also incurred non-cash depreciation, amortization and stock-based compensation expenses of \$9.0 million, \$0.5 million and \$7.5 million, respectively. Additional sources of cash included: (i) \$13.9 million in decreased accounts receivable associated with the timing of our ship and debit credit settlements with distributors, (ii) \$5.8 million for deferred income on sales to distributors, resulting from increased distributor shipments, and (iii) a \$4.6 million decrease in prepaid expenses due primarily to decreased legal fees and the amortization of our prepaid inventory, (iv) \$4.3 million for increased taxes payable and accrued liabilities resulting from higher net income, which has increased our accrued tax liability. These sources of cash were offset to a large degree by a \$22.8 million use of cash to increase our inventory levels.

Our investing activities in the nine months ended September 30, 2011 resulted in a \$45.9 million net use of cash, consisting of (i) \$16.2 million for purchases of property and equipment, primarily manufacturing equipment to support our growth, and building improvements in connection with our research and development facility in New Jersey, (ii) \$6.9 million paid in relation to the acquisition of QSpeed (refer to Note 14, Acquisitions, in our Notes to Condensed Consolidated Financial Statements), (iii) \$8.0 million in connection with our lease line of credit to SemiSouth (refer to Note 17, Lease Line to Third Party, in our Notes to Condensed Consolidated Financial Statements) and (iv) \$16.1 million, net, for purchases of held-to-maturity investments. These uses of cash were partially offset by \$2.2 million in proceeds from the sale of capital equipment.

Our investing activities in the nine months ended September 30, 2010 resulted in a \$36.5 million net use of cash, consisting of (i) \$21.8 million for purchases of property and equipment, primarily manufacturing equipment to support our increased production requirements, and the implementation of a solar array to supply power for our corporate headquarters facility, (ii) \$8.6 million to purchase the assets of an early-stage research and development company (see Note 14, Acquisitions, of our Notes to Condensed Consolidated Financial Statements for details), (iii) \$6.8 million for the issuance of notes receivable to third parties and (iv) \$0.7 million of net purchases of held-to-maturity investments, partially offset by \$1.4 million of proceeds from the sale of property and equipment.

Our financing activities in the nine months ended September 30, 2011, resulted in a \$21.2 million net use of cash. Financing activities consisted primarily of \$35.8 million for the repurchase of our common stock and \$4.3 million for the payment of dividends to stockholders. This cash usage was partially offset by proceeds of \$18.2 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan.

In the nine months ended September 30, 2010, the following components comprised of our financing activities. Proceeds from financing activities included (i) \$18.0 million from the issuance of shares through our employee stock purchase plan and the exercise of employee stock options, and (ii) \$1.0 million of excess tax benefits from stock options exercised. These sources of cash were almost completely offset by (i) \$14.0 million for the repurchase of our common stock, (ii) \$4.2 million for the payment of dividends to stockholders and (iii) \$0.8 million for the repurchase

and retirement of shares related to employee income tax withholding.

We paid dividends on a quarterly basis in 2010, which resulted in approximately a \$1.4 million use of cash per quarter. In October 2010, our board of directors declared an additional 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 2011. The first three quarterly dividend payments of approximately \$1.4 million each were made on March 31, 2011, June 30, 2011 and September 30, 2011, to stockholders of record as of February 28, 2011, May 31, 2011 and August 31, 2011, respectively. We expect the remaining quarterly dividend will result in a similar use of cash. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our 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 our stockholders.

In May, 2009, we announced that our board of directors had authorized the use of up to \$25.0 million for the

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repurchase of shares of our common stock. From May 14, 2009 to December 31, 2009, we purchased 0.5 million shares of our common stock for approximately \$11.0 million (including fees), and in the first two quarters of 2010 we purchased 0.4 million shares of our common stock for approximately \$14.0 million (including fees), concluding this repurchase program.

In February 2011, our board of directors authorized the use of \$50.0 million for the repurchase of our common stock. Repurchases were executed according to certain pre-defined price/volume guidelines set by the board of directors. In the nine months ended September 30, 2011, we repurchased 1.1 million shares for a total cost of \$35.8 million, leaving \$14.2 million remaining for future repurchases. In November 2011, our board of directors authorized the use of an additional \$30.0 million for the repurchase of our common stock. Repurchases in connection with this plan may begin when the February 2011 repurchase plan has concluded. Similar to the February 2011 plan, repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors. There is currently no expiration date for either repurchase program.

As of September 30, 2011 we have a contractual obligation related to income tax, which is comprised primarily of unrecognized tax benefits of approximately \$33.8 million. The tax obligation was classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our condensed consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next year.

In the first quarter of 2011, the IRS informed us that it intends to propose adjustments to our taxable income for fiscal years 2003 thru 2006 related to our intercompany research and development cost-sharing arrangement and related issues. We believe the IRS's position with respect to the proposed adjustment is without merit, inconsistent with applicable tax law, and that we have a meritorious defense to our position. Accordingly, we intend to continue to challenge the IRS's position on this matter vigorously. While we believe the IRS's asserted position on this matter is not supported by applicable law, we may be required to make additional payments to the IRS pending resolution of this matter. If this matter is litigated and the IRS is able to successfully sustain its position, our results of operations and financial condition could be materially and adversely affected. Resolution of this matter is not anticipated within the next year (refer to Note 9, Provision for Income Taxes, in our Notes to Condensed Consolidated Financial Statements).

In February 2011, we entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the amended terms of the agreement, SemiSouth can borrow up to \$8.6 million through January 2013. As of September 30, 2011, a total of \$8.0 million had been funded, comprising \$3.9 million funded, less payments withheld under this lease arrangement to finance capital equipment commencing in February 2011, and \$4.1 million paid as deposits on equipment which we will lease to SemiSouth upon delivery of such equipment. We included the lease line receivable in Other Assets and Prepaid Expenses and Other Current Assets in our condensed consolidated balance sheet at September 30, 2011 (refer to Note 17, Lease Line to Third Party, in our Notes to Condensed Consolidated Financial Statements).

There were no other material changes, other than stated in the liquidity section above, outside of the ordinary course of business in our contractual commitments reported in our Annual Report on Form 10-K for the year ended December 31, 2010.

Our existing cash, cash equivalents and investment balances may change during the year due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to our acquisitions. Our intent is to permanently reinvest our earnings from foreign operations. Current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations since the majority of our cash and investments are held in the U.S. In the event funds from foreign operations are needed to

fund operations in the United States and if U.S. tax has not already been previously provided, we would be required to accrue and pay additional U.S. taxes in connection with the repatriation of any funds.

If our operating results deteriorate during the remainder of 2011, either as a result of a decrease in customer demand, or severe pricing pressures from our customers or our competitors, or for other reasons, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, use our current financing or seek additional financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

#### Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, Fair Value Measurement, ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and



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results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). We will apply these amendments prospectively beginning in the first quarter of 2012. We are currently evaluating the impact the application of these amendments will have on our consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (ASC Topic 220). This amendment gives an entity two options to present the total of comprehensive income, the components of net income, and the components of other comprehensive income. An entity can elect to present comprehensive income in either (1) a single continuous statement of comprehensive income, or (2) in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. We will apply this amendment beginning in the first quarter of 2012. We are currently evaluating the impact the application of this amendment will have on our condensed consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment, (ASC Topic 350). Under the amendments in this ASU, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity also has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted.

On January 1, 2011, we adopted the following accounting pronouncements:

In December 2010, FASB issued Accounting Standards Update (ASU) No. 2010-29, Business Combinations (ASC Topic 805). The amendments in this update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also improve the usefulness of the pro forma revenue and earnings disclosures by requiring a description of the nature and amount of material, nonrecurring pro forma adjustments that are directly attributable to the business combination(s). The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on our condensed consolidated financial statements.

In December 2010, FASB issued ASU No. 2010-28, Intangibles - Goodwill and Other (ASC Topic 350). Under Topic 350 on goodwill and other intangible assets, testing for goodwill impairment is a two-step test. When a goodwill impairment test is performed (either on an annual or interim basis), an entity must assess whether the carrying amount of a reporting unit exceeds its fair value (Step 1). If it does, an entity must perform an additional test to determine whether goodwill has been impaired and to calculate the amount of that impairment (Step 2). The amendments in this update modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that goodwill impairment

exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors require that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on our condensed consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update (“ASU”) No. 2010-06, “Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Instruments.” ASU No. 2010-06 amends ASC 820 to require additional disclosures regarding fair value measurements. Specifically, the ASU requires entities to disclose the amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy, to disclose reasons for

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any transfers in or out of Level 3 and to separately disclose information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements. In addition, the ASU also amends ASC 820 to clarify certain existing disclosure requirements. Except for the requirement to disclose information about purchases, sales, issuances and settlements in the reconciliation of recurring Level 3 measurements separately, the amendments to ASC 820 made by ASU No. 2010-06 were effective for our 2010 interim and annual reporting periods. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements were effective for our 2011 interim and annual reporting periods. The adoption of these provisions did not have a material impact on our condensed consolidated financial statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has not been a material change in our exposure to interest rate and foreign currency risks from that described in our 2010 Annual Report on Form 10-K.

**Interest Rate Risk.** Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than one year from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than one year from the balance sheet date are classified as long-term investments. We do not use derivative financial instruments in our investment portfolio to manage our interest rate risk, foreign currency risk, or for any other purpose. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. We do not hold any instruments for trading purposes. At September 30, 2011, and December 31, 2010, we held primarily cash equivalents and short-term and long-term investments with fixed interest rates.

**Foreign Currency Exchange Risk.** Our primary transactional currency is U.S. dollars, however we have sales offices in various foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts.

Two of our major suppliers, Epson and ROHM Lapis Semiconductor Co., Ltd., or Lapis, (Formerly OKI), have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these 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 Power Integrations and each of these suppliers.

Nevertheless, as a result of our above-mentioned supplier agreements, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. All else being equal, a 10% change in the value of the U.S. dollar compared to the Japanese yen would result in a corresponding change in our gross margin of approximately 1.5 percentage points; this sensitivity may increase or decrease depending on the percentage of our wafer supply that we purchase from our Japanese suppliers and could subject our gross profit and operating results to the potential for material fluctuations.

At September 30, 2011, and December 31, 2010, we did not have material cash or investments denominated in foreign currencies, and therefore had no material foreign currency exchange risk related to our cash and investments.

ITEM 4. CONTROLS AND PROCEDURES

**Limitation on Effectiveness of Controls**

Any control system, no matter how well designed and operated, can provide only reasonable assurance as to the tested objectives. The design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential

future conditions, regardless of how remote. The inherent limitations in any control system include the realities that judgments related to decision-making can be faulty, and that reduced effectiveness in controls can occur because of simple errors or mistakes. Due to the inherent limitations in a cost-effective control system, misstatements due to error may occur and may not be detected.

#### Evaluation of Disclosure Controls and Procedures

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our

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management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2011, which materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information with respect to this item may be found in Note 12, Legal Proceedings and Contingencies, in our Notes to Condensed Consolidated Financial Statements included earlier in this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

ITEM 1A. RISK FACTORS

In addition to the other information in this report, the following factors should be considered carefully in evaluating our business before purchasing shares of our stock. The risks facing our business have not changed substantively from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2010, except for those risk factors below designated by an asterisk (\*).

Our quarterly operating results are volatile and difficult to predict. If we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly. Our net revenues and operating results have varied significantly in the past, are difficult to forecast, are subject to numerous factors both within and outside of our control, and may fluctuate significantly in the future. As a result, our quarterly operating results could fall below the expectations of public market analysts or investors. If that occurs, the price of our stock may decline.

Some of the factors that could affect our operating results include the following:

- the volume and timing of orders received from customers;
- competitive pressures on selling prices;
- the demand for our products declining in the major end markets we serve, which may occur due to competitive factors, supply-chain fluctuations or changes in macroeconomic conditions;
- the volume and timing of delivery of orders placed by us with our wafer foundries and assembly subcontractors;
- the inability to adequately protect or enforce our intellectual property rights;
- fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen;
- an audit by the Internal Revenue Service, which is asserting that we owe additional taxes relating to a number of tax related positions;
- continued impact of recently enacted changes in securities laws and regulations, including potential risks resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002;

- expenses we are required to incur (or choose to incur) in connection with our intellectual property litigations;
- the lengthy timing of our sales cycle;
- undetected defects and failures in meeting the exact specifications required by our products;

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- reliance on international sales activities for a substantial portion of our net revenues;
- our ability to develop and bring to market new products and technologies on a timely basis;
- risks associated with acquisitions and strategic investments;
- our ability to successfully integrate, or realize the expected benefits from, our acquisitions;
- changes in environmental laws and regulations, including with respect to energy consumption and climate change;
- interruptions in our information technology systems; and
- earthquakes, terrorists acts or other disasters.

We do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and our business may suffer. Our business is characterized by short-term customer orders and shipment schedules. Our customer base is highly concentrated, and a relatively small number of distributors, OEMs and merchant power supply manufacturers account for a significant portion of our revenues. Our top ten customers, including distributors, accounted for 65% and 62% of our net revenues for the nine months ended September 30, 2011 and the year ended December 31, 2010, respectively. The ordering patterns of some of our existing large customers have been unpredictable in the past and we expect that customer-ordering patterns will continue to be unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without significant penalty to the customer. In the past, we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time.

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. The high-voltage power supply industry is intensely competitive and characterized by significant price sensitivity. Our products face competition from alternative technologies, such as linear transformers, discrete switcher power supplies, and other integrated and hybrid solutions. If the price of competing solutions decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized go outside the cost-effective range of our products, some of these alternative technologies can be used more cost effectively. In addition, as our patents expire, our competitors could legally begin using the technology covered by the expired patents in their products, potentially increasing the performance of their products and/or decreasing the cost of their products, which may enable our competitors to compete more effectively. Our current patents may or may not inhibit our competitors from getting any benefit from an expired patent. Our U.S. patents have expiration dates ranging from 2011 to 2028. We cannot assure that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market. We believe our failure to compete successfully in the high-voltage power supply business, including our ability to introduce new products with higher average selling prices, would materially harm our operating results.

If demand for our products declines in our major end markets, our net revenues will decrease. A limited number of applications of our products, such as cellphone chargers, standby power supplies for PCs, and power supplies for home appliances comprise a significant percentage of our net revenues. We expect that a significant level of our net revenues and operating results will continue to be dependent upon these applications in the near term. The demand for



these products has been highly cyclical and has been impacted by economic downturns in the past. Any economic slowdown in the end markets that we serve could cause a slowdown in demand for our ICs. When our customers are not successful in maintaining high levels of demand for their products, their demand for our ICs decreases, which adversely affects our operating results. Any significant downturn in demand in these markets would cause our net revenues to decline and could cause the price of our stock to fall.

\*We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient quantities of wafers, our business may suffer. We have supply arrangements for the production of wafers with Lapis, XFAB Renesas Technology Corporation ("Renesas") and Epson. Our contracts with these suppliers expire in April 2018, December 2012, August 2014 and December 2020, respectively. Although certain aspects of our relationships with Lapis, XFAB, Renesas and Epson are contractual, many important aspects of these relationships depend on their continued

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cooperation. We cannot assure that we will continue to work successfully with Lapis, XFAB, Renesas and Epson in the future, and that the wafer foundries' capacity will meet our needs. Additionally, one or more of these wafer foundries could seek an early termination of our wafer supply agreements. Any serious disruption in the supply of wafers from Lapis, XFAB, Renesas or Epson could harm our business. We estimate that it would take 12 to 24 months from the time we identified an alternate manufacturing source to produce wafers with acceptable manufacturing yields in sufficient quantities to meet our needs.

Although we provide our foundries with rolling forecasts of our production requirements, their ability to provide wafers to us is ultimately limited by the available capacity of the wafer foundry. Any reduction in wafer foundry capacity available to us could require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions to meet our customers' requirements, or may limit our ability to meet demand for our products. Further, to the extent demand for our products exceeds wafer foundry capacity, this could inhibit us from expanding our business and harm relationships with our customers. Any of these concessions or limitations could harm our business.

If our third-party suppliers and independent subcontractors do not produce our wafers and assemble our finished products at acceptable yields, our net revenues may decline. We depend on independent foundries to produce wafers, and independent subcontractors to assemble and test finished products, at acceptable yields and to deliver them to us in a timely manner. The failure of the foundries to supply us wafers at acceptable yields could prevent us from selling our products to our customers and would likely cause a decline in our net revenues and gross margin. In addition, our IC assembly process requires our manufacturers to use a high-voltage molding compounds that have been available from only a few suppliers. These compounds and their specified processing conditions require a more exacting level of process control than normally required for standard IC packages. Unavailability of assembly materials or problems with the assembly process can materially and adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

In addition, if prices for commodities used in our products increase significantly, raw material costs would increase for our suppliers which could result in an increase in the prices our suppliers charge us. (Recent increases in the price of gold and copper, which is used in our IC packages and lead frames, respectively, have in fact increased our product costs to some degree.) To the extent we are not able to pass these costs on to our customers; this would have an adverse effect on our gross margins.

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. Our success depends upon our ability to continue our technological innovation and protect our intellectual property, including patents, trade secrets, copyrights and know-how. We are currently engaged in litigation to enforce our intellectual property rights, and associated expenses have been, and are expected to remain, material and have adversely affected our operating results. We cannot assure that the steps we have taken to protect our intellectual property will be adequate to prevent misappropriation, or that others will not develop competitive technologies or products. From time to time, we have received, and we may receive in the future, communications alleging possible infringement of patents or other intellectual property rights of others. Costly litigation may be necessary to enforce our intellectual property rights or to defend us against claimed infringement. The failure to obtain necessary licenses and other rights, and/or litigation arising out of infringement claims could cause us to lose market share and harm our business.

As our patents expire, we will lose intellectual property protection previously afforded by those patents. Additionally, the laws of some foreign countries in which our technology is or may in the future be licensed may not protect our intellectual property rights to the same extent as the laws of the United States, thus limiting the protections applicable to our technology.

\*Fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen, may impact our gross margin. Two of our major suppliers, Epson and Lapis, have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these 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 Power Integrations and each of these suppliers.

\*We are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of tax related positions, and if we are not successful in defending our positions we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future. Our operations are

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subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by the IRS and state, local and foreign tax authorities. In connection with an IRS audit of our United States federal income tax returns for fiscal years 2002 and 2003, the IRS proposed a material adjustment related to our research and development cost-sharing arrangement. We are disputing the proposed adjustment, but at the request of the IRS, we agreed to rollover the disputed proposed adjustment into the audit of our United States Federal income tax returns for fiscal years 2004 through 2006. In the quarter ended March 31, 2011, we received Notices of Proposed Adjustments from the IRS showing proposed changes to our taxable income for fiscal years 2003 through 2006, primarily related to our intercompany research and development cost-sharing arrangement. The fiscal years 2007 through 2009 are also under audit by the IRS. While the IRS has not completed its audit for these years, we anticipate that it will again propose an adjustment related to our intercompany research and development cost-sharing arrangement.

We believe the IRS's position with respect to the proposed adjustment related to our research and development cost-sharing arrangement is inconsistent with applicable tax law, and that we have a meritorious defense to our position. Accordingly, we intend to continue to challenge the IRS's position on this matter vigorously. While we believe the IRS's asserted position on this matter is not supported by applicable law, we may be required to make additional payments in order to resolve this matter. If this matter is litigated and the IRS is able to successfully sustain its position, our results of operations and financial condition could be materially and adversely affected. Resolution of this matter could take considerable time, possibly years.

Securities laws and regulations, including potential risk resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002, will continue to impact our results. Complying with the requirements of the Sarbanes-Oxley Act of 2002 and NASDAQ's conditions for continued listing have imposed significant legal and financial compliance costs, and are expected to continue to impose significant costs and management burden on us. These rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly qualified members to serve on our audit committee. Further, the rules and regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which are to become effective throughout 2011, are also expected to continue to impose significant costs and management burden on us. Additionally, because these laws, regulations and standards promulgated by the Sarbanes-Oxley Act are, and those promulgated under the Dodd-Frank Act when they become effective are expected to be, subject to varying interpretations, their application in practice may evolve over time as new guidance becomes available. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

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 certain technologies. We are currently involved in a number of patent litigation matters and the outcome of the litigation is uncertain. See Note 12, Legal Proceedings and Contingencies, in our Notes to Condensed Consolidated Financial Statements in Item 1 of Part I. For example, in one of our patent suits the infringing company has been found to infringe four of our patents. Despite the favorable court finding, the infringing party filed an appeal to the damages awarded. In another matter, we are being sued for patent infringement in China, where the outcome of litigation can be more uncertain than in the United States. Should we ultimately be determined to be infringing on another party's patents, or if an injunction is issued against us while litigation is pending on those claims, such result could have an adverse impact on our ability to sell products found to be infringing, either directly or indirectly. In the event of an adverse outcome, we may be required to pay substantial damages, stop our manufacture, use, sale, or importation of infringing products, or obtain licenses to the intellectual property we are found to have infringed. We have also incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits, including the appeal of the case we won, and our involvement in this litigation and any future intellectual property litigation could adversely affect sales and divert the efforts and attention of our technical and management personnel, whether or not such litigation is resolved in our favor. Thus, even if we are

successful in these lawsuits, the benefits of this success may fail to outweigh the significant legal costs we will have incurred.

Because the sales cycle for our products can be lengthy, we may incur substantial expenses before we generate significant revenues, if any. Our products are generally incorporated into a customer's products at the design stage. However, customer decisions to use our products, commonly referred to as design wins, can often require us to expend significant research and development and sales and marketing resources without any assurance of success. These significant research and development and sales and marketing resources often precede volume sales, if any, by a year or more. The value of any design win will largely depend upon the commercial success of the customer's product. We cannot assure that we will continue to

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achieve design wins or that any design win will result in future revenues. If a customer decides at the design stage not to incorporate our products into its product, we may not have another opportunity for a design win with respect to that product for many months or years.

Our products must meet exacting specifications, and undetected defects and failures may occur which may cause customers to return or stop buying our products. Our customers generally establish demanding specifications for quality, performance and reliability, and our products must meet these specifications. ICs as complex as those we sell often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments. We have from time to time in the past experienced product quality, performance or reliability problems. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support and customer expenses, delays in or cancellations or rescheduling of orders or shipments and product returns or discounts, any of which would harm our operating results.

Our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. Sales to customers outside of the Americas account for, and have accounted for a large portion of our net revenues, including approximately 96% and 95% of our net revenues for nine months ended September 30, 2011 and the year ended December 31, 2010, respectively. If our international sales declined and we were unable to increase domestic sales, our revenues would decline and our operating results would be harmed. International sales involve a number of risks to us, including:

- potential insolvency of international distributors and representatives;
- reduced protection for intellectual property rights in some countries;
- the impact of recessionary environments in economies outside the United States;
- tariffs and other trade barriers and restrictions;
- the burdens of complying with a variety of foreign and applicable U.S. Federal and state laws; and
- foreign-currency exchange risk.

Our failure to adequately address these risks could reduce our international sales and materially and adversely affect our operating results. Furthermore, because substantially all of our foreign sales are denominated in U.S. dollars, increases in the value of the dollar cause the price of our products in foreign markets to rise, making our products more expensive relative to competing products priced in local currencies.

If our efforts to enhance existing products and introduce new products are not successful, we may not be able to generate demand for our products. Our success depends in significant part upon our ability to develop new ICs for high-voltage power conversion for existing and new markets, to introduce these products in a timely manner and to have these products selected for design into products of leading manufacturers. New product introduction schedules are subject to the risks and uncertainties that typically accompany development and delivery of complex technologies to the market place, including product development delays and defects. If we fail to develop and sell new products in a timely manner then our net revenues could decline.

In addition, we cannot be sure that we will be able to adjust to changing market demands as quickly and cost-effectively as necessary to compete successfully. Furthermore, we cannot assure that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Our failure, or our customers' failure, to develop and introduce new products

successfully and in a timely manner would harm our business. In addition, customers may defer or return orders for existing products in response to the introduction of new products. When a potential liability exists we will maintain reserves for customer returns, however we cannot assure that these reserves will be adequate.

If our products do not penetrate additional markets, our business will not grow as we expect. We believe that our future success depends in part upon our ability to penetrate additional markets for our products. We cannot assure that we will be able to overcome the marketing or technological challenges necessary to penetrate additional markets. To the extent that a competitor penetrates additional markets before we do, or takes market share from us in our existing markets, our net revenues and financial condition could be materially adversely affected.

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We must attract and retain qualified personnel to be successful and competition for qualified personnel is intense in our market. Our success depends to a significant extent upon the continued service of our executive officers and other key management and technical personnel, and on our ability to continue to attract, retain and motivate qualified personnel, such as experienced analog design engineers and systems applications engineers. The competition for these employees is intense, particularly in Silicon Valley. The loss of the services of one or more of our engineers, executive officers or other key personnel could harm our business. In addition, if one or more of these individuals leaves our employ, and we are unable to quickly and efficiently replace those individuals with qualified personnel who can smoothly transition into their new roles, our business may suffer. We do not have long-term employment contracts with, and we do not have in place key person life insurance policies on, any of our employees.

We are exposed to risks associated with acquisitions and strategic investments. We have made, and in the future intend to make, acquisitions of, and investments in, companies, technologies or products in existing, related or new markets. Acquisitions involve numerous risks, including but not limited to:

- inability to realize anticipated benefits, which may occur due to any of the reasons described below, or for other unanticipated reasons;

- the risk of litigation or disputes with customers, suppliers, partners or stockholders of an acquisition target arising from a proposed or completed transaction;

- impairment of acquired intangible assets and goodwill as a result of changing business conditions, technological advancements or worse-than-expected performance, which would adversely affect our financial results; and

- unknown, underestimated and/or undisclosed commitments, liabilities or issues not discovered in our due diligence of such transactions.

We also make strategic investments in other companies, which may decline in value and/or not meet desired objectives. The success of these strategic investments depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with strategic partners. Moreover, these investments are often illiquid, such that it may be difficult or impossible for us to monetize such investments.

Our inability to successfully integrate, or realize the expected benefits from, our acquisitions could adversely affect our results. We have made acquisitions of other businesses, including Qspeed Semiconductor Inc., and there is a risk that integration difficulties may cause us not to realize expected benefits. The success of the acquisitions could depend, in part, on our ability to realize the anticipated benefits and cost savings (if any) from combining the businesses of the acquired companies and our business, which may take longer to realize than expected.

Changes in environmental laws and regulations may increase our costs related to obsolete products in our existing inventory. Changing environmental regulations and the timetable to implement them continue to impact our customers' demand for our products. As a result there could be an increase in our inventory obsolescence costs for products manufactured prior to our customers' adoption of new regulations. Currently we have limited visibility into our customers' strategies to implement these changing environmental regulations into their business. The inability to accurately determine our customers' strategies could increase our inventory costs related to obsolescence.

\*Interruptions in our information technology systems could adversely affect our business. We rely on the efficient and uninterrupted operation of complex information technology systems and networks to operate our business. Any significant system or network disruption, including but not limited to new system implementations, computer viruses, security breaches, or energy blackouts could have a material adverse impact on our operations, sales and operating results. We have implemented measures to manage our risks related to such disruptions, but such disruptions could



still occur and negatively impact our operations and financial results. In addition, we may incur additional costs to remedy the damages caused by these disruptions or security breaches.

In the event of an earthquake, terrorist act or other disaster, our operations may be interrupted and our business would be harmed. Our principal executive offices and operating facilities are situated near San Francisco, California, and most of our major suppliers, which are wafer foundries and assembly houses, are located in areas that have been subject to severe earthquakes, such as Japan. Many of our suppliers are also susceptible to other disasters such as tropical storms, typhoons or tsunamis. In the event of a disaster, such as the recent earthquake and tsunami in Japan, we or one or more of our major suppliers may be temporarily unable to continue operations and may suffer significant property damage. Any interruption in our ability or that of our major suppliers to continue operations could delay the development and shipment of

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our products and have a substantial negative impact on our financial statements.

Like other U.S. companies, our business and operating results are subject to uncertainties arising out of economic consequences of current and potential military actions or terrorist activities and associated political instability, and the impact of heightened security concerns on domestic and international travel and commerce. These uncertainties could also lead to delays or cancellations of customer orders, a general decrease in corporate spending or our inability to effectively market and sell our products. Any of these results could substantially harm our business and results of operations, causing a decrease in our revenues.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

## ISSUER PURCHASES OF EQUITY SECURITIES

| Period                            | Total Number of Shares Purchased (1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet be Repurchased Under the Plans or Programs (in millions) |
|-----------------------------------|--------------------------------------|------------------------------|--|--|
| July 1 to July 30, 2011           | 56,161                               | \$36.63                      | 56,161   | \$43.6   |
| August 1 to August 31, 2011       | 544,259                              | \$31.34                      | 544,259  | \$26.5   |
| September 1 to September 30, 2011 | 386,250                              | \$31.83                      | 386,250  | \$14.2   |
| Total                             | 986,670                              |                              | 986,670  |  |

In February 2011, our board of directors authorized the use of \$50.0 million for the repurchase of our common (1) stock. Repurchases are executed according to certain pre-defined price/volume guidelines set by the board of directors. This stock repurchase program commenced in February 2011, and has no expiration date.

In November 2011, our board of directors authorized the use of an additional \$30.0 million for the repurchase of our common stock. Repurchases in connection with this plan may begin when the February 2011 repurchase plan has concluded. Similar to the February 2011 plan, repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors. There is currently no expiration date for this stock repurchase program.

## ITEM 6. EXHIBITS

See the Exhibit Index immediately following the signature page to this Quarterly Report on Form 10-Q, which is incorporated by reference here.

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SIGNATURES

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

POWER INTEGRATIONS, INC.

Dated: November 7, 2011

By: /s/ SANDEEP NAYYAR  
Sandeep Nayyar  
Chief Financial Officer (Duly Authorized  
Officer and Principal Financial Officer and  
Chief Accounting Officer)

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INDEX TO EXHIBITS

| EXHIBIT<br>NUMBER | DESCRIPTION  |
|-------------------|--|
| 3.1               | Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Annual Report on Form 10-K on March 16, 1999, SEC File No. 000-23441.)                               |
| 3.2               | Certificate of Amendment to Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.3 to our Annual Report on Form 10-K on March 22, 2002, SEC File No. 000-23441.)   |
| 3.3               | Certificate of Amendment to Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.) |
| 3.4               | Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.2 to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.)                                       |
| 4.1               | Reference is made to Exhibits 3.1 to 3.4.  |
| 31.1              | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2              | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1              | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**  |
| 32.2              | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**  |
| 101.INS           | XBRL Instance Document   |
| 101.SCH           | XBRL Taxonomy Extension Schema Document  |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB           | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase Document   |

All references in the table above to previously filed documents or descriptions are incorporating those documents and descriptions by reference thereto.

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\*\*The certifications attached as Exhibits 32.1 and 32.2 accompanying this Form 10-Q, are not deemed filed with the SEC, and are not to be incorporated by reference into any filing of Power Integrations, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of

this Form 10-Q, irrespective of any general incorporation language contained in such filing.