

POWER INTEGRATIONS INC

Form 10-Q

May 06, 2010

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2010.**

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**

**POWER INTEGRATIONS, INC.**

(Exact name of registrant as specified in its charter)

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**DELAWARE**  
(State or other jurisdiction of  
Incorporation or organization)

**94-3065014**  
(I.R.S. Employer  
Identification No.)

**5245 Hellyer Avenue, San Jose, California 95138**  
(Address of principal executive offices) (Zip code)

**(408) 414-9200**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  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  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) 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                          | Outstanding at April 27, 2010 |
|--------------------------------|-------------------------------|
| Common Stock, \$.001 par value | 27,987,466 shares             |

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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. In some cases, forward-looking statements are indicated by the use of such words as would, could, will, may, expect, believe, should, anticipate, future, intend, plan, estimate, predict, potential, targets, seek or continue and similar words and phrases, including the negatives or other variations of these terms. 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: 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. In evaluating these statements, you should specifically consider 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.

**Table of Contents****PART 1. FINANCIAL INFORMATION**

## ITEM 1. FINANCIAL STATEMENTS

**POWER INTEGRATIONS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)****(In thousands)**

|  | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|---------------------------|------------------------------|
| <b>ASSETS</b>  |                           |                              |
| <b>CURRENT ASSETS:</b>   |                           |                              |
| Cash and cash equivalents  | \$ 125,295                | \$ 134,974                   |
| Restricted cash  | 250                       | 250                          |
| Short-term investments   | 22,129                    | 20,567                       |
| Accounts receivable, net of allowance of \$302 in both 2010 and 2009 | 27,586                    | 21,756                       |
| Inventories  | 31,426                    | 26,248                       |
| Deferred tax assets  | 1,486                     | 1,389                        |
| Prepaid expenses and other current assets                            | 13,130                    | 10,691                       |
| Total current assets   | 221,302                   | 215,875                      |
| LONG-TERM INVESTMENTS  | 62,562                    | 40,100                       |
| PROPERTY AND EQUIPMENT, net  | 65,877                    | 62,381                       |
| INTANGIBLE ASSETS, net   | 2,927                     | 3,099                        |
| GOODWILL   | 1,824                     | 1,824                        |
| DEFERRED TAX ASSETS  | 12,996                    | 14,590                       |
| OTHER ASSETS   | 6,683                     | 6,698                        |
| Total assets   | \$ 374,171                | \$ 344,567                   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                          |                           |                              |
| <b>CURRENT LIABILITIES:</b>  |                           |                              |
| Accounts payable   | \$ 26,158                 | \$ 16,944                    |
| Accrued payroll and related expenses                                 | 5,227                     | 6,145                        |
| Taxes payable  | 453                       | 478                          |
| Deferred income on sales to distributors                             | 11,917                    | 9,040                        |
| Accrued professional and other fees                                  | 2,141                     | 3,018                        |
| Other accrued liabilities  | 402                       | 291                          |
| Total current liabilities  | 46,298                    | 35,916                       |
| LONG-TERM INCOME TAXES PAYABLE                                       | 25,023                    | 23,859                       |
| Total liabilities  | 71,321                    | 59,775                       |
| <b>COMMITMENTS AND CONTINGENCIES (Note 8, 10 and 11)</b>             |                           |                              |
| <b>STOCKHOLDERS' EQUITY:</b>   |                           |                              |

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|   |            |            |
|---|------------|------------|
| Common stock                                  | 28         | 27         |
| Additional paid-in capital                    | 157,193    | 150,021    |
| Accumulated other comprehensive income (loss) | (46)       | 4          |
| Retained earnings                             | 145,675    | 134,740    |
| Total stockholders' equity                    | 302,850    | 284,792    |
| Total liabilities and stockholders' equity    | \$ 374,171 | \$ 344,567 |

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

**Table of Contents****POWER INTEGRATIONS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)****(In thousands, except per share amounts)**

|   | <b>Three Months<br/>Ended<br/>March 31,</b> |               |
|---|---|---------------|
|   | <b>2010</b>                                 | <b>2009</b>   |
| NET REVENUES                                    | \$ 71,507                                   | \$ 40,289     |
| COST OF REVENUES                                | 35,585                                      | 19,357        |
| <b>GROSS PROFIT</b>                             | <b>35,922</b>                               | <b>20,932</b> |
| OPERATING EXPENSES:                             |   |               |
| Research and development                        | 8,111                                       | 7,724         |
| Sales and marketing                             | 6,920                                       | 6,222         |
| General and administrative                      | 6,013                                       | 5,681         |
| Total operating expenses                        | 21,044                                      | 19,627        |
| <b>INCOME FROM OPERATIONS</b>                   | <b>14,878</b>                               | <b>1,305</b>  |
| OTHER INCOME, NET                               | 494   | 824           |
| <b>INCOME BEFORE PROVISION FOR INCOME TAXES</b> | <b>15,372</b>                               | <b>2,129</b>  |
| PROVISION FOR INCOME TAXES                      | 3,058                                       | 1,725         |
| <b>NET INCOME</b>                               | <b>\$ 12,314</b>                            | <b>\$ 404</b> |
| EARNINGS PER SHARE:                             |   |               |
| Basic   | \$ 0.45                                     | \$ 0.01       |
| Diluted   | \$ 0.42                                     | \$ 0.01       |
| SHARES USED IN PER SHARE CALCULATION:           |   |               |
| Basic   | 27,470                                      | 27,048        |
| Diluted   | 29,358                                      | 28,057        |

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

**Table of Contents****POWER INTEGRATIONS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)****(In thousands)**

|   | <b>Three Months Ended<br/>March 31,</b> |                 |
|---|---|-----------------|
|   | <b>2010</b>                             | <b>2009</b>     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |   |                 |
| Net income  | \$ 12,314                               | \$ 404          |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |                 |
| Depreciation and amortization   | 2,933                                   | 2,496           |
| Stock-based compensation expense  | 2,027                                   | 3,986           |
| Amortization of premium/(discount) on held to maturity investments                | 350                                     | (53)            |
| Loss on sales of property, plant and equipment                                    | 13                                      |                 |
| Deferred income taxes   | 1,498                                   | 1,232           |
| Reduction in allowances accounts receivable and other                             |   | (99)            |
| Excess tax benefit from stock options exercised                                   | (1,176)                                 | (5)             |
| Tax benefit associated with employee stock plans                                  | 2,535                                   | 73              |
| Change in operating assets and liabilities:                                       |   |                 |
| Accounts receivable   | (5,830)                                 | (5,031)         |
| Inventories   | (5,185)                                 | (250)           |
| Prepaid expenses and other current assets   | (672)                                   | (729)           |
| Accounts payable  | 6,295                                   | (894)           |
| Income taxes payable and accrued liabilities                                      | (1,200)                                 | (1,055)         |
| Deferred income on sales to distributors  | 2,877                                   | 1,774           |
| <b>Net cash provided by operating activities</b>                                  | <b>16,779</b>                           | <b>1,849</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |   |                 |
| Purchases of property and equipment   | (3,360)                                 | (1,767)         |
| Advance for acquisition of business   | (1,750)                                 |                 |
| Purchases of held-to-maturity investments   | (27,224)                                | (2,755)         |
| Proceeds from maturities of held-to-maturity investments                          | 2,850                                   | 3,000           |
| <b>Net cash used in investing activities</b>                                      | <b>(29,484)</b>                         | <b>(1,522)</b>  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |   |                 |
| Issuance of common stock under employee stock plans                               | 10,035                                  | 4,117           |
| Repurchase of common stock  | (6,038)                                 | (17,635)        |
| Retirement of shares for income tax withholding                                   | (769)                                   |                 |
| Payments to employees for tender offer  |   | (9,048)         |
| Excess tax benefit from stock options exercised                                   | 1,176                                   | 5               |
| Payments of dividends to stockholders   | (1,378)                                 | (672)           |
| <b>Net cash provided by (used in) financing activities</b>                        | <b>3,026</b>                            | <b>(23,233)</b> |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>(9,679)</b>                          | <b>(22,906)</b> |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>134,974</b>                          | <b>167,472</b>  |



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|  |            |            |
|--|------------|------------|
| CASH AND CASH EQUIVALENTS AT END OF PERIOD                                     | \$ 125,295 | \$ 144,566 |
| <b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b> |            |            |
| Unpaid property and equipment, net   | \$ 2,918   | \$ 168     |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                       |            |            |
| Cash paid for interest   | \$         | \$ 3       |
| Cash paid for income taxes, net of refunds                                     | \$ 16      | \$ 173     |

The accompanying notes are an integral part of these 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, 2009 included in its Form 10-K filed on February 26, 2010 with the Securities and Exchange Commission.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

*Cash and Cash Equivalents and Short-Term and Long-Term Investments*

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. 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 March 31, 2010 and December 31, 2009, the Company's short-term and long-term investments consisted of U.S. government backed securities, municipal bonds, corporate commercial paper 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.

*Restricted Cash*

The Company's restricted cash balance of \$0.3 million at March 31, 2010 consists of an interest-bearing certificate of deposit at Union Bank of California. The certificate of deposit (CD) earns interest at a rate of approximately 0.25% and is renewed every 90 days. The current maturity for the certificate of deposit is July 22, 2010. The Company entered into a security agreement with the bank, whereby it agreed to maintain \$0.3 million in an interest-bearing certificate of deposit in order to secure commercial letters of credit or standby letters of credit up to the deposit amount. As of March 31, 2010, there were two outstanding letters of credit totaling approximately \$0.2 million. This CD agreement remains in effect until cancellation of the Company's letters of credit.

*Fair Value of Financial Instruments*

The Company measures its financial assets and liabilities in accordance with U.S. GAAP. For financial instruments, including cash and cash equivalents, short-term and long-term investments and accounts receivable, the carrying amounts approximate fair value due to their short maturities.

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

*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 OEM's and merchant power supply manufactures, assuming all other criteria for revenue recognition are met as described below.

The Company applies the provisions of Accounting Standard Codification ( ASC ) 605-10 ( ASC 605-10 ) (Formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*) 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. The Company assesses collectability based on the creditworthiness of the customer as determined by credit checks performed by the Company as well as the customer's payment history.

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 March 31, 2010 and December 31, 2009 was approximately \$23.7 million and \$17.6 million, respectively. The total deferred cost as of March 31, 2010 and December 31, 2009 was approximately \$11.8 million and \$8.6 million, respectively. In addition, the Company determined the impact of the returns and pricing uncertainties related to the deferred revenue to be negligible over the reported periods.

*Common Stock and Common Stock Dividends*

In May 2009, the Company's board of directors authorized the use of \$25 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. In the three months ended March 31, 2010, the Company purchased 0.2 million shares for approximately \$6.1 million (including fees), leaving approximately \$7.9 million remaining for future share repurchases. There is currently no expiration date for this 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 shareholders of record at the end of each quarter in 2010. The first of four quarterly dividend payments was made on March 31, 2010, in the amount of \$1.4 million. The Company expects the remaining dividends will result in approximately the same quarterly use of cash.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)***Use of Estimates*

The preparation of financial statements in conformity with 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 allowances for receivables 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*

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

|                                   | <b>Three Months Ended</b> |               |
|-----------------------------------|---------------------------|---------------|
|                                   | <b>March 31,</b>          |               |
|                                   | <b>2010</b>               | <b>2009</b>   |
| Net income                        | \$ 12,314                 | \$ 404        |
| Other comprehensive income:       |                           |               |
| Translation adjustments           | (50)                      | (47)          |
| Tax impact                        | 10                        | 38            |
| <b>Total comprehensive income</b> | <b>\$ 12,274</b>          | <b>\$ 395</b> |

*Prepaid Expenses and Other Current Assets (in thousands)*

|                                  | <b>March 31,</b> | <b>December 31,</b> |
|----------------------------------|------------------|---------------------|
|                                  | <b>2010</b>      | <b>2009</b>         |
| Prepaid legal fees               | \$ 3,000         | \$ 4,000            |
| Prepaid inventory (Note 16)      | 2,551            | 2,858               |
| Advance to third party (Note 15) | 1,750            |                     |
| Prepaid income tax               | 2,818            | 1,295               |
| Prepaid maintenance agreements   | 474              | 527                 |
| Interest receivable              | 820              | 693                 |
| Other                            | 1,717            | 1,318               |
| <b>Total</b>                     | <b>\$ 13,130</b> | <b>\$ 10,691</b>    |

*Segment Reporting*

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The Company is organized and operates as one business segment: the design, development, manufacture and marketing of proprietary, high-voltage, analog integrated circuits for use primarily in the AC-to-DC and DC-to-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.

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

**3. STOCK PLANS AND STOCK-BASED COMPENSATION:**

**Stock Plans**

As of March 31, 2010, the Company had five stock-based employee 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, stock appreciation rights, performance stock awards and other stock awards to employees, directors and consultants. As of March 31, 2010, the maximum remaining number of shares that may be issued under the 2007 Plan was 8,376,193 shares, which consists of the shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options 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 Plan, whereby the board of directors could grant incentive stock options and non-qualified stock options 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 non-qualified stock options could 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 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

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maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of 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. Beginning in January 2009, 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.

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

On July 28, 2009, the Directors Plan was amended generally to prohibit outstanding options from being amended to reduce the exercise price of such outstanding options or 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 was approved by the Company s directors; stockholder approval was not required at that time and was not sought. 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 March 31, 2010, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000 shares. 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.

*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).

Prior to February 1, 2009, each offering period consisted of four consecutive purchase periods of approximately six months duration, or such other number or duration as the Board determined. Beginning February 1, 2009, each offering period consists of one purchase period of approximately six months duration. In accordance with Accounting Standards Codification (ASC) 718-10 (Formerly Statement of Financial Accounting Standards (SFAS) 123 (revised), *Share-Based Payment*), the Company s change in the Purchase Plan offering period was considered a plan modification, and following the guidance of ASC 718-10, the Company accelerated the stock-based compensation expense for the modified purchase rights for a total of \$1.6 million in the first quarter of 2009. This amount was reflected in the operating expense captions in the Company s condensed consolidated statement of income at March 31, 2009. An aggregate of 3,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of March 31, 2010, 2,160,597 shares had been purchased and 839,403 shares were reserved for future issuance under the Purchase Plan.

**Stock-Based Compensation**

The Company applies the provisions of ASC 718-10. Under the provisions of ASC 718-10, the Company recognizes the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. The Company uses estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation to recognize. Changes in these estimates could result in changes to the Company s compensation charges.

As of March 31, 2010 there were approximately \$9.2 million, net of expected forfeitures, of total unrecognized compensation costs related to stock options. The unrecognized compensation costs at March 31, 2010 are expected to be recognized over a weighted-average period of 2.50 years.



**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

As of March 31, 2010, the Company had \$1.3 million and \$0.7 million of total unrecognized compensation expense, net of estimated forfeitures, related to performance-based share grants and restricted stock units, respectively. The unamortized compensation expense will be recognized on a straight-line basis. The weighted average estimated remaining lives are 0.75 years and 3.69 years for performance-based share grants and restricted stock units, respectively.

As of March 31, 2010, the total unrecognized compensation cost under the Purchase Plan to purchase the Company's common stock was approximately \$0.3 million. The Company will amortize this cost on a straight-line basis over approximately 0.5 years.

In the first quarter of 2010 a total of approximately \$2.0 million was recorded as stock-based compensation expense, and was comprised of approximately \$1.4 million related to stock options, \$0.3 million related to performance shares, \$41,000 related to restricted stock units, \$0.3 million related to the Purchase Plan and approximately \$7,000 in compensation expense amortized from beginning inventory. In the first quarter of 2009 a total of approximately \$4.0 million was recorded as stock compensation expense, comprised of approximately \$1.8 million related to stock options, including performance shares of \$0.1 million, \$2.2 million related to the Purchase Plan and a reduction of approximately \$32,000 in compensation expense capitalized into inventory.

*Determining Fair Value*

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

*Expected Volatility.* The Company calculates expected volatility as a weighted average of implied volatility and historical volatility.

*Expected Term.* The Company developed 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 method on the implied yield available on a U.S. Treasury note with a term 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 stock price of the Company's common stock on a quarterly basis.

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

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 for the first quarter of 2009:

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2010(1)</b>            | <b>2009</b> |
| Risk-free interest rates                                  |                           | 1.76%       |
| Expected volatility rates                                 |                           | 48%         |
| Expected dividend yield                                   |                           | 0.52%       |
| Expected term of stock options (in years)                 |                           | 5.01        |
| Weighted-average grant date fair value of options granted |                           | \$ 7.66     |

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- (1) The Company did not grant stock options in the first quarter of 2010, and therefore no assumptions were reported for that period. The company granted restricted stock units to new-hire employees in the first quarter of 2010; see the *Restricted Stock Units* section below for details.

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## POWER INTEGRATIONS, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

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 |         |
|--|--------------------|---------|
|  | March 31,          |         |
|  | 2010               | 2009    |
| Risk-free interest rates                                 | 0.17%              | 0.39%   |
| Expected volatility rates                                | 36%                | 56%     |
| Expected dividend yield                                  | 0.55%              | 0.52%   |
| Expected term of purchase right (in years)               | 0.5                | 0.5     |
| Weighted-average estimated fair value of purchase rights | \$ 7.96            | \$ 6.02 |

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three months ended March 31, 2010 and March 31, 2009 (in thousands).

|                            | Three Months Ended |                 |
|----------------------------|--------------------|-----------------|
|                            | March 31,          |                 |
|                            | 2010               | 2009            |
| Cost of revenues           | \$ 157             | \$ 162          |
| Research and development   | 727                | 1,836           |
| Sales and marketing        | 410                | 994             |
| General and administrative | 733                | 993             |
| <b>Total</b>               | <b>\$ 2,027</b>    | <b>\$ 3,985</b> |

A summary of stock option activity under the Plans, excluding performance-based shares and restricted stock units, as of March 31, 2010, and changes during the three 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<br>Value<br>(in thousands) |
|--------------------------------------|--------------------------|---|--|---|
| Outstanding at January 1, 2010       | 5,724                    | \$ 21.65                                  |  |   |
| Granted                              |                          |   |  |   |
| Exercised                            | (433)                    | 19.12                                     |  |   |
| Forfeited or expired                 | (174)                    | 35.99                                     |  |   |
| <b>Outstanding at March 31, 2010</b> | <b>5,118</b>             | <b>\$ 21.37</b>                           | <b>5.24</b>  | <b>\$ 101,488</b>                                 |
| Exercisable at March 31, 2010        | 4,025                    | \$ 21.13                                  | 4.31   | \$ 80,796   |

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|  |       |          |      |            |
|--|-------|----------|------|------------|
| Vested and expected to vest at<br>March 31, 2010 | 5,043 | \$ 21.37 | 5.19 | \$ 100,025 |
|--|-------|----------|------|------------|

The Company did not grant stock options in the three months ended March 31, 2010. The weighted-average, grant-date fair value of options granted for the three months ended March 31, 2009 was \$7.66. The total intrinsic value of options exercised during the three months ended March 31, 2010 and 2009 was \$8,279,981 and \$673,016, respectively.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)***Performance-based Awards*

Under the performance-based awards program, the Company awards a target number of units at the beginning of the performance year. 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.

During the quarter ended March 31, 2010, the Company issued 52,400 performance-based awards to executives. As the net revenue and non-GAAP operating earnings are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, will be 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 was 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. The grant-date fair value of these awards was approximately \$32.07.

In January 2010, it was determined that the Company had reached the established performance targets for the 2009 performance-based awards. Accordingly, the 119,200 performance-based awards, which were fully vested, were released to the Company's employees and executives in 2010. Of this amount 23,392 shares were purchased by the Company and retired for executive income tax withholding. The grant date fair value for these awards was \$18.66.

Each performance-based award granted from the 2007 plan will reduce the number of options available for issuance by 2.0 shares.

*Restricted Stock Units (RSUs)*

The Company grants restricted stock units to employees under the 2007 Plan. The RSUs typically vest ratably over a certain period of time, subject to the employee's continued service to the Company over that period. RSUs granted to employees typically vest over a four-year period, and are converted into shares of the Company's common stock upon vesting on a one-for-one basis. 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 options available for issuance by 2.0 shares.

A summary of RSUs outstanding as of March 31, 2010 was as follows (in thousands):

|                                | Shares<br>(in thousands) | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|--------------------------------|--------------------------|--|---|
| Outstanding at January 1, 2010 | 13                       |  |   |
| Granted                        | 13                       |  |   |
| Exercised                      |                          |  |   |
| Forfeited or expired           |                          |  |   |
| Outstanding at March 31, 2010  | 26                       | 2.19   | \$ 1,065  |

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|   |    |      |    |     |
|---|----|------|----|-----|
| Vested and expected to vest at March 31, 2010 | 22 | 2.19 | \$ | 904 |
|---|----|------|----|-----|

The weighted-average grant-date fair value of RSUs awarded in the three months ended March 31, 2010 was approximately \$36.41; there were no RSUs granted in the three months ended March 31, 2009.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****4. 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):

|                 | <b>March 31,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|-----------------|---------------------------|----------------------------------|
| Raw materials   | \$ 7,335                  | \$ 5,870                         |
| Work-in-process | 9,116                     | 7,694                            |
| Finished goods  | 14,975                    | 12,684                           |
| Total           | \$ 31,426                 | \$ 26,248                        |

**5. INTANGIBLE ASSETS:**

Intangible assets consist primarily of acquired licenses and patent rights and are reported net of accumulated amortization. The Company amortizes the cost of an intangible asset over the term of the acquired license or patent rights, which ranges from five to ten years. Amortization for all acquired intangible assets was approximately \$0.2 million in both the three months ended March 31, 2010 and March 31, 2009. The Company does not believe there is any significant residual value associated with the following intangible assets (in thousands):

|                         | <b>March 31, 2010</b> |                                     |            | <b>December 31, 2009</b> |                                     |            |
|-------------------------|-----------------------|-------------------------------------|------------|--------------------------|-------------------------------------|------------|
|                         | <b>Gross</b>          | <b>Accumulated<br/>Amortization</b> | <b>Net</b> | <b>Gross</b>             | <b>Accumulated<br/>Amortization</b> | <b>Net</b> |
|                         | <b>(in thousands)</b> |                                     |            |                          |                                     |            |
| Technology licenses     | \$ 3,000              | \$ (1,200)                          | \$ 1,800   | \$ 3,000                 | \$ (1,125)                          | \$ 1,875   |
| Patent rights           | 1,949                 | (1,597)                             | 352        | 1,949                    | (1,542)                             | 407        |
| Developed technology    | 1,140                 | (366)                               | 774        | 1,140                    | (326)                               | 814        |
| Other intangibles       | 37                    | (36)                                | 1          | 37                       | (34)                                | 3          |
| Total intangible assets | \$ 6,126              | \$ (3,199)                          | \$ 2,927   | \$ 6,126                 | \$ (3,027)                          | \$ 3,099   |

The estimated future amortization expense related to intangible assets at March 31, 2010 is as follows:

| <b>Fiscal Year</b>        | <b>Estimated<br/>Amortization<br/>(in thousands)</b> |
|---------------------------|--|
| 2010 (remaining 9 months) | \$ 512   |
| 2011                      | 651  |

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|            |          |
|------------|----------|
| 2012       | 463      |
| 2013       | 463      |
| 2014       | 463      |
| Thereafter | 375      |
| Total      | \$ 2,927 |



**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****6. SIGNIFICANT CUSTOMER CONCENTRATIONS AND SALES INFORMATION:***Customer Concentration*

Ten customers accounted for approximately 60% and 65% of net revenues for the three months ended March 31, 2010 and March 31, 2009, 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. Two customers, both distributors of the Company's products, accounted for 13% and 11% of net revenues in the three months ended March 31, 2010. The same two customers accounted for 16% and 11% of net revenues in the three months ended March 31, 2009.

*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 March 31, 2010 and December 31, 2009, 68% and 63%, respectively, of accounts receivable were concentrated with the Company's top ten customers.

As of March 31, 2010, two customers, both distributors of the Company's products, accounted for 19% and 13% of accounts receivable. As of December 31, 2009 one customer, also a distributor of the Company's products, accounted for 15% of accounts receivable. No other customer accounted for more than 10% of net accounts receivable in the periods mentioned.

*International Sales*

The Company markets its products through its sales personnel and a worldwide network of distributors. As a percentage of total net revenues, international sales, which consist of domestic and foreign sales to distributors and direct customers outside of the Americas, are comprised of the following:

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2010</b>               | <b>2009</b> |
| Hong Kong/China                               | 28%                       | 30%         |
| Korea   | 21%                       | 22%         |
| Taiwan  | 26%                       | 21%         |
| Western Europe (excluding Germany)            | 7%                        | 10%         |
| Germany                                       | 3%                        | 4%          |
| Japan   | 6%                        | 4%          |
| Singapore                                     | 2%                        | 1%          |
| Other   | 2%                        | 3%          |
| <b>Total revenue, excluding the Americas.</b> | <b>95%</b>                | <b>95%</b>  |

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The remainder of the Company's sales were to customers within the Americas, primarily located in the United States, with some customers located in Mexico and Brazil.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)***Product Sales*

Approximately 98% to 99% of the Company's sales in the three months ended March 31, 2010 and 2009 were from its three primary groupings of AC-DC power-conversion products – TOPSwitch, TinySwitch and LinkSwitch. Approximately 1% to 2% of the Company's sales came from other product families, principally the Company's DPA-Switch family of high-voltage DC-DC products.

Revenue mix by product grouping was as follows:

| Product Family | Three Months Ended<br>March 31, |      |
|----------------|---------------------------------|------|
|                | 2010                            | 2009 |
| TinySwitch     | 39%                             | 46%  |
| LinkSwitch     | 36%                             | 29%  |
| TOPSwitch      | 24%                             | 23%  |
| Other          | 1%                              | 2%   |

**7. 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 exercise of outstanding common stock options and RSUs, as computed using the treasury stock method.

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

|  | Three Months Ended<br>March 31, |         |
|--|---------------------------------|---------|
|  | 2010                            | 2009    |
| Basic earnings per share:              |                                 |         |
| Net income                             | \$ 12,314                       | \$ 404  |
| Weighted-average common shares         | 27,470                          | 27,048  |
| Basic earnings per share               | \$ 0.45                         | \$ 0.01 |
| Diluted earnings per share (1) :       |                                 |         |
| Net income                             | \$ 12,314                       | \$ 404  |
| Weighted-average common shares         | 27,470                          | 27,048  |
| Effect of dilutive securities:         |                                 |         |
| Employee stock plans                   | 1,888                           | 1,009   |
| Diluted weighted-average common shares | 29,358                          | 28,057  |

|                            |         |         |
|----------------------------|---------|---------|
| Diluted earnings per share | \$ 0.42 | \$ 0.01 |
|----------------------------|---------|---------|

- (1) Power Integrations includes the shares underlying performance-based awards in the calculation of diluted EPS when they become contingently issuable per ASC 260-10 (Formerly SFAS No. 128, *Earnings per Share*) and excludes such shares when they are not contingently issuable. The Company has excluded all performance-based awards underlying the fiscal 2010 awards as those shares are not contingently issuable.

Options to purchase 86,462 shares and 3,152,588 shares of the Company's common stock outstanding for the quarters outstanding March 31, 2010 and 2009, respectively, were not included in the computation of diluted earnings per share for the periods then ended because exercise prices of the options were greater than the average market price of the Company's common stock during those periods and, therefore, their effect would have been anti-dilutive.

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

**8. INCOME TAXES:**

The Company accounts 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.

In assessing the realizability of deferred tax assets, the Company 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. The Company 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 managements 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 March 31, 2010, the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets primarily due to recent California budget legislation. 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 months ended March 31, 2010 and 2009 were 20% and 81%, respectively. The Company's effective tax rate was lower than the statutory rate of 35% for the three months ended March 31, 2010 primarily due to the favorable impact from the geographic distribution of its world-wide earnings partially offset by a valuation allowance on its California deferred tax assets. The Company's effective tax rate was higher than the statutory rate of 35% for the three months ended March 31, 2009 primarily due to the recent California budget legislation which resulted in the Company reducing the value of its state deferred tax assets by \$0.3 million and recording an income tax provision of \$0.8 million to establish a valuation allowance to reserve previously recorded net tax benefits from California tax credits. This was partially offset by the geographic distribution of the Company's world-wide earnings.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. In 2009, the IRS completed its audit of the Company's 2002 and 2003 tax returns. The Company and the IRS were unable to reach an agreement on the adjustment it proposed for those years with respect to the Company's research and development cost-sharing arrangement. The Company agreed to rollover this disputed issue into the audit of the Company's tax returns for fiscal years 2004 through 2006 which is now in progress, in order to allow the IRS to further evaluate multiple year data related to the Company's research and development cost-sharing arrangement.

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.

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

**9. INDEMNIFICATIONS:**

The Company sells products to its distributors under contracts, collectively referred to as Distributor Sales Agreements (DSAs). 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 hardware is 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 March 31, 2010. 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.

**10. COMMITMENTS AND CONTINGENCIES:**

From time to time the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. See note 11 below. In accordance with ASC 450-10 (Formerly SFAS No. 5, *Accounting for Contingencies*), 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.

The Company purchases wafers through purchase orders from the foundries. All but one of the Company's wafer agreements are executed in U.S. currency. That agreement requires the wafer purchases to be in Japanese yen; however, the purchase price within that agreement is fixed at a base rate and allows for some sharing of the impact of exchange rate fluctuations from the base rate. The currency fluctuation experienced between the time invoices are submitted to the Company until the time the yen is purchased and remitted to the supplier is a financial responsibility of the Company.

One of the Company's wafer supply agreements which provides for the purchase of wafers in U.S. dollars also provides for a sharing of the impact of the exchange rate fluctuation between the Japanese yen and the U.S. dollar. Each year, the Company and the supplier agree to a fixed exchange rate. The fluctuation from this annual exchange rate is shared equally between both parties. The Company accounted for the gain or loss related to the payment of these transactions as part of other income or expense.

**11. LEGAL PROCEEDINGS:**

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 \$33,981,781 in damages. Although the jury awarded damages,

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

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 \$6,116,720, 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. 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 at the end of July. The Court will now consider the issue of willfulness and issue a ruling.

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

On June 14, 2007, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against Shanghai SIM-BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. sister corporation, BCD Semiconductor Corporation (referred to collectively as BCD). The Company's complaint alleged that certain integrated circuits produced by BCD infringe certain of the Company's patents, seeking,

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among other things, an order enjoining BCD from infringing on its patents and an award for damages resulting from the alleged infringement. The Company voluntarily dismissed the California case against BCD on October 15, 2007 and filed a substantially identical complaint against BCD in the United States District Court for the District of Delaware on October 15, 2007. On January 21, 2008, BCD moved to dismiss the Delaware action for lack of personal jurisdiction in favor of a declaratory judgment action it filed against Power Integrations on the same patents in the U.S. District Court, Northern District of California, discussed in further detail below. On September 9, 2008, the Court denied BCD's motion to dismiss, and BCD thereafter dismissed its separate declaratory judgment action and answered the Company's complaint on September 19, 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. The parties held a mediation session with the Court on January 30, 2009 and subsequently entered into a settlement agreement in February 2009. Pursuant to the settlement agreement, the Court entered an order prohibiting BCD from manufacturing or selling the products involved in the lawsuit in the United States or from selling such products for use in end products destined for the U.S. market.

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 case between the parties pending the entry of final judgment in that case. The Company has challenged the Court's stay order with respect to products already found to infringe in the other case, and 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 case is currently set for the trial to begin on October 4, 2010.

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 three of the 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



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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that two of the patents are unenforceable. The Court set a schedule for the case with claim construction proceedings beginning this summer and a further case management conference in September. On May 5, 2010, Fairchild and SG filed an amended answer including counterclaims accusing the Company of infringing two patents; the Company is evaluating these new claims and intends to contest them vigorously.

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. Power Integrations Netherlands and its representative offices have filed jurisdictional challenges to the proceedings, which 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 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). The Company believes the Fairchild and SG claims are without merit and intends to contest them vigorously.

In 2009, the IRS completed its audit of the Company's 2002 and 2003 tax returns. The Company and the IRS were unable to reach an agreement on the adjustment it proposed for those years with respect to the Company's research and development cost-sharing arrangement. The Company agreed to rollover this disputed issue into the audit of the Company's tax returns for fiscal years 2004 through 2006 which is now in progress, in order to allow the IRS to further evaluate multiple year data related to the Company's research and development cost-sharing arrangement.

On July 4, 2008 Azzurri Technology GmbH (in the following referred to as Azzurri ) filed a complaint in the amount of EUR 1,247,832.07 plus interest against the Company in the Regional Court Munich I (Germany). This complaint was received by the Company on or about September 16, 2008. In its complaint, Azzurri, a former distributor and agent of the Company's products in Germany and Austria, alleged that pursuant to mandatory European law it is entitled to a compensation claim in said amount following the termination of the distributor agreement by the Company even though the distribution agreement did not provide for such payment. In its written pleading the Company has denied such claims. In the meantime, however, the parties have entered into a settlement agreement; with a written pleading dated March 26, 2010, Azzurri has therefore withdrawn its claim. With a written pleading dated April 14, 2010, the Company has informed the Regional Court Munich I that it accepts the claim withdrawal. The terms of this settlement agreement have no material impact on the Company's financial statements.

There can be no assurance that Power Integrations will prevail in the litigation with Fairchild. This litigation, 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. In addition, the Company is unable to predict the outcome of the other legal proceedings and matters described above. 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.

The Company is also subject to a variety of other claims and suits that arise from time to time in the ordinary course of business. These matters are subject to inherent uncertainties and the Company's view of these matters may change in the future and could result in charges that would have a material adverse impact on its financial position, results of operations, or cash flows.

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**POWER INTEGRATIONS, INC.**

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

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**12. RECENT ACCOUNTING PRONOUNCEMENTS:**

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 are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of these provisions of ASU No. 2010-06 did not have a material impact on the Company's consolidated financial statements. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements is effective for interim and annual reporting periods beginning after December 15, 2010. The Company does not expect the adoption of the remaining provisions of this ASU to have a material impact on the Company's condensed consolidated financial statements.

On January 1, 2010, the Company adopted the following accounting pronouncement:

In December 2008, the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) issued ASC 715-20 (Formerly FASB staff position, or FSP, 132(R)-1, *Employer's Disclosures about Postretirement Benefit Plan Assets*). ASC 715-20 requires additional disclosures about assets held in an employer's defined benefit pension or other postretirement plan. This guidance is effective for fiscal years ending after December 15, 2009 and was adopted by the Company in 2010. There was no material impact to the Company's condensed consolidated financial statements as a result of the adoption of this guidance.

**13. 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 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. On a recurring basis, the Company could measure certain financial assets at fair value, including its marketable securities.

The Company entered into an agreement (see Note 14) in the second quarter of 2009 pursuant to which, among other things, it may be obligated to acquire another company if that company meets certain financial performance conditions. At March 31, 2010, the Company determined the carrying 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). The Company will update the fair value quarterly and record any changes to the Company's consolidated financial statements.

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, government, state, municipal and provincial obligations, and are



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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. The Company held no Level 3 investments at March 31, 2010 and December 31, 2009.

The fair value hierarchy of the Company's marketable securities was as follows (in thousands):

| Description                     | Balance at<br>March 31,<br>2010 | Fair Value Measurement at<br>Reporting<br>Date Using:                            |  |
|---------------------------------|---------------------------------|--|--|
|                                 |                                 | Quoted Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) |
| Commercial paper                | \$ 10,292                       | \$   | \$ 10,292  |
| Money market funds              | 84,874                          | 84,874   |  |
| U.S. Government debt securities | 17,304                          |  | 17,304   |
| Corporate Securities            | 67,084                          |  | 67,084   |
| <b>Total</b>                    | <b>\$ 179,554</b>               | <b>\$ 84,874</b>   | <b>\$ 94,680</b>                                       |

**14. ROYALTY AGREEMENT:**

During the second fiscal quarter of 2009, the Company entered into a license agreement with a company for the use of its technology in exchange for a prepaid royalty of \$5.25 million. The Company will amortize the royalty to cost of revenues based on the Company's sales of products incorporating the licensed technology. The prepaid royalty is included in other assets in its March 31, 2010 condensed consolidated balance sheet.

**15. DEFINITIVE AGREEMENT:**

On February 26, 2010, the Company entered into a definitive agreement to purchase the assets of an early-stage research and development company for cash totaling \$11.8 million. As of December 31, 2009, the Company provided \$1.2 million toward the purchase price; this amount is included in other assets in the Company's condensed consolidated balance sheet at March 31, 2010. The Company also provided to this early-stage company an advance for a loan of \$1.8 million in the current quarter (which amount was held in escrow until April 6, 2010 at which time the money was released to this company and the loan became effective). The advance for the loan is included in prepaid expenses in the Company's condensed consolidated balance sheet at March 31, 2010. The Company expects to deposit the remaining purchase price in escrow in the second quarter of 2010, and to complete the acquisition in approximately July of 2010.

**16. SUPPLIER AGREEMENT:**

Under an amended wafer supply agreement the Company prepaid \$3.1 million for raw materials in 2008. Purchases of raw material under this agreement will be made based upon future production build plans of the Company's wafers. As of March 31, 2010, \$2.6 million remained as

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prepaid under this agreement. The Company included the refundable prepayment in prepaid expenses and other current assets in its March 31, 2010 and December 31, 2009 condensed consolidated balance sheets.

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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, 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, 2009 filed with the SEC on February 26, 2010. This discussion contains forward-looking statements 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 proprietary, high-voltage, analog integrated circuits ( ICs ) for use in electronic power supplies, also known as switched-mode power supplies. Our ICs 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 fixtures.

We believe that our products enable power supplies 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 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, such as the recent economic downturn, 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 rate of our revenues, income and cash flow depends primarily on our penetration of the power supply market, as well as 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 over the past several 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 concerns about the inefficiency of traditional incandescent lighting are resulting in the adoption of alternative lighting technologies such as light-emitting diodes (LEDs). We believe this presents a significant opportunity for us because our ICs are used in power-supply circuitry for high-voltage, or offline, LED lighting applications.

*Expand our addressable market to include high-power applications.* We believe we have developed 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 PCs, as well as power supplies for LED streetlights, game consoles, and notebook computers.

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Our quarterly and annual operating results are difficult to predict and subject to significant fluctuations. Customers typically can cancel or reschedule orders without significant penalty. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile. For example, like many semiconductor companies, we experienced a sharp decrease in demand for our products beginning in the fourth quarter of 2008 as a result of the global economic downturn, but have experienced a strong recovery in demand since the first quarter of 2009, reflecting an improvement in business conditions industry-wide as well as increased penetration of our products into our addressable markets. Also, we plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. The strong demand for our products in recent periods has resulted in shortages of certain products and caused an extension of our lead times for delivery to customers. We are adding production capacity in order to ensure that we can satisfy customer demand; however, if we do not have adequate inventory of products to satisfy our customers' demand, our operating results may be impacted.

Moreover, during periods where lead times have increased, there have been instances of double ordering in the industry. Following these periods, there is increased risk of order cancellation or rescheduling as supply catches up and lead times are reduced.

Our net revenues were \$71.5 million and \$40.3 million in the first quarters of 2010 and 2009, respectively. The growth of revenues year over year reflects overall growth in demand for electronic products, as well as increased penetration of our products into our addressable markets. Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for 60% and 65% of our net revenues in the first quarters of 2010 and 2009, respectively. Our top two customers, both distributors of our products, collectively accounted for approximately 24% of our net revenues in the first quarter of 2010. In the first quarter of 2009 the same two customers accounted for 27% of net revenues. International sales comprised 95% of our net revenues in both periods.

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. Also, 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 such, our unit costs and gross profit margin are impacted by the volume of units we produce.

Our gross profit, defined as net revenues less cost of revenues, was \$35.9 million, or 50% of net revenues, in the first quarter of 2010, compared to \$20.9 million, or 52% of net revenues, in the same period of 2009. The reduction in our gross margin in the first quarter of 2010 was driven by several factors, including: increased sales of recently introduced products, which tend to have a lower gross margin than early generation products; the weakening of the U.S. dollar compared with the Japanese yen, which increases the cost of our silicon wafers; and the expiration of our royalty agreement with Panasonic in mid-2009, which eliminated a small but high-margin revenue stream. While we cannot predict the future direction of our gross margin because many of the factors influencing it are outside of our control, we are working to increase our gross margin through a combination of product-cost reductions and the development of new products and technologies aimed at increasing the value of our ICs to customers.

Total operating expenses in the first quarters of 2010 and 2009 were \$21.0 million and \$19.6 million, respectively. The increase in operating expenses in 2010 compared with 2009 was driven primarily by: increased payroll and related expenses as a result of increased headcount in research and development as well as sales and marketing, and increased general and administrative expenses as a result of increased legal fees related to patent litigation. These increases were partially offset by lower stock-based compensation expenses; operating expenses for the first quarter of 2009 included \$1.6 million of stock-based compensation expenses resulting from a change to our employee stock purchase plan from a 2-year offering period to a 6-month offering period. In addition there were fewer stock awards granted in the first quarter of 2010 versus the same period in 2009.

### **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 requires management to make estimates and assumptions that affect

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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.

Our critical accounting policies and estimates are as follows:

revenue recognition;

stock-based compensation;

estimating sales returns and allowances;

estimating distributor pricing credits;

estimating allowance for doubtful accounts;

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 ). As such, 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 the title transfer for sales to OEM s and merchant power supply manufactures, 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.



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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 our 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 consolidated balance sheets. The total deferred revenue as of March 31, 2010 and December 31, 2009 was approximately \$23.7 million and \$17.6 million, respectively. The total deferred cost as of March 31, 2010 and December 31, 2009 was approximately \$11.8 million and \$8.6 million, respectively.

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### **Stock-based compensation**

We apply the provisions of ASC 718-10 (Formerly SFAS No. 123(R), *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. Changes in these estimates could result in changes to our compensation charges.

### **Estimating sales returns and allowances**

Net revenues consist primarily of product revenues reduced by estimated sales returns and allowances and pricing credits (discussed below). To estimate sales returns and allowances, we analyze, both when we initially establish the reserve and then each quarter when we review the adequacy of the reserve, the following factors: historical returns, current economic trends, levels of inventories of our products held by our distributors, and changes in customer demand and acceptance of our products. This reserve represents a reserve of the gross profit on estimated future returns and is reflected as a reduction to accounts receivable in the accompanying consolidated balance sheets. Increases to the reserve are recorded as a reduction to net revenues equal to the expected customer credit memo, and a corresponding credit is made to cost of revenues equal to the estimated cost of the product to be returned. The net difference, or gross margin, is recorded as an addition to the reserve. Because the reserve for sales returns and allowances is based on our judgments and estimates, particularly as to future customer demand and level of acceptance of our products, our reserves may not be adequate to cover actual sales returns and other allowances. If our reserves are not adequate, our future net revenues and cost of revenues could be adversely affected.

### **Estimating distributor pricing credits**

Historically, between one-half and two-thirds of our total sales have been made to 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 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 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.

If we reduce our distribution list prices, we give our distributors protection against these price declines in the form of credits on products they hold in inventory. These credits are referred to as price protection. Since we do not recognize revenue until the distributor sells the product to its customers, we generally do not need to provide reserves for price protection. However, in rare instances we must consider price protection in the analysis of reserve requirements, as there may be a timing gap between a price decline and the issuance of price protection credits. If a price protection reserve is required, we will 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 net revenues. We analyze distribution price declines and levels of inventory in the distributor channels in determining the reserve levels required. If our reserves are not adequate, our net revenues could be adversely affected.

### **Estimating allowance for doubtful accounts**

We maintain an allowance for losses we may incur as a result of our customers' inability to make required payments. Any increase in the allowance for doubtful accounts results in a corresponding increase in our general and administrative expenses. In establishing this allowance, and in evaluating the adequacy of the allowance for doubtful accounts each quarter, we analyze historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms. If the financial condition of one or more of our customers deteriorates, resulting in their inability to make payments, or if we otherwise underestimate the losses we incur as a result of our customers' inability to pay us, we could be required to increase our allowance for doubtful accounts, which could in turn adversely affect our operating results.

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### **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 March 31, 2010, we continue to maintain a valuation allowance on a portion of our California deferred tax assets primarily due to recent California budget legislation. 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.

### **Goodwill and intangible assets**

In accordance with ASC 350-10 (Formerly SFAS No. 142, *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 goodwill for impairment in the fourth quarter 2009, and concluded that no impairment existed.

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 (Formerly SFAS No. 144, *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.

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by the amount by which the carrying amount of the asset exceeds the fair value of the asset. We would present assets to be disposed of separately in the balance sheet and would report the assets at the lower of the carrying amount or fair value less costs to sell, and would no longer depreciate the assets and liabilities of a disposed group classified as held for sale. Currently, we have no impairment of long-lived assets nor any assets held for sale.

**Results of Operations**

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

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| Net revenues                                    | 100.0%                                  | 100.0%      |
| Cost of revenues                                | 49.8                                    | 48.0        |
| <b>Gross profit.</b>                            | <b>50.2</b>                             | <b>52.0</b> |
| Operating expenses:                             |   |             |
| Research and development                        | 11.3                                    | 19.2        |
| Sales and marketing                             | 9.7                                     | 15.4        |
| General and administrative                      | 8.4                                     | 14.1        |
| <b>Total operating expenses</b>                 | <b>29.4</b>                             | <b>48.7</b> |
| <b>Income from operations</b>                   | <b>20.8</b>                             | <b>3.3</b>  |
| Total other income, net                         | 0.7                                     | 2.0         |
| <b>Income before provision for income taxes</b> | <b>21.5</b>                             | <b>5.3</b>  |
| Provision for income taxes                      | 4.3                                     | 4.3         |
| <b>Net income</b>                               | <b>17.2%</b>                            | <b>1.0%</b> |

*Comparison of the Three Months Ended March 31, 2010 and 2009*

*Net revenues.* Net revenues consist of revenues from product sales, which are calculated net of returns and allowances, plus, in the first quarter of 2009, license fees and royalties. Net revenues for the three months ended March 31, 2010 were \$71.5 million compared to \$40.3 million for the three months ended March 31, 2009, an increase of \$31.2 million, or 77%. The increase in revenues reflects a combination of higher overall demand for electronic devices incorporating our products and greater penetration of our products in the AC-DC power supply market. The growth in revenues was broad-based, with higher sales into all of our major end markets (communications, computer, consumer and industrial), including applications such as appliances, home entertainment equipment, mobile-phone chargers, LED lights and utility meters.

Our net revenue mix by product family for the three months ended March 31, 2010 compared with the three months ended March 31, 2009 was as follows:

| <b>Product Family</b> | <b>Three Months Ended<br/>March 31,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2010</b>                             | <b>2009</b> |
| TinySwitch            | 39%                                     | 46%         |
| LinkSwitch            | 36%                                     | 29%         |
| TOPSwitch             | 24%                                     | 23%         |
| Other                 | 1%                                      | 2%          |

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Approximate revenue mix by end markets served for the three months ended March 31, 2010 compared with the three months ended March 31, 2009:

| <b>End Market</b> | <b>Three Months Ended</b> |             |
|-------------------|---------------------------|-------------|
|                   | <b>March 31,</b>          |             |
|                   | <b>2010</b>               | <b>2009</b> |
| Consumer          | 36%                       | 34%         |
| Communication     | 32%                       | 33%         |
| Computer          | 12%                       | 15%         |
| Industrial        | 20%                       | 18%         |

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International sales, defined as sales outside of the Americas based on ship to customer locations, were \$67.6 million in the first quarter of 2010 compared with \$38.3 million for the same period in 2009, an increase of approximately \$29.3 million. International sales represented 95% of net revenues in both periods. Although the power supplies incorporating our products are designed in and distributed to end markets worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region were 84% and 81% of our net revenues for the three months ended March 31, 2010 and 2009, respectively.

Product sales through distributors accounted for 66% of net product sales for the first quarter of 2010 and 34% of net product sales were to OEMs and power supply manufactures; the corresponding figures for the first quarter of 2009 were 67% and 33%, respectively. Two customers, both distributors of our products, accounted for 13% and 11% of net revenues in the three months ended March 31, 2010. The same two distributors accounted for 16% and 11% of net revenues in the three months ended March 31, 2009. No other customer accounted for 10% or more of our revenues in the periods mentioned.

*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 for the three months ended March 31, 2010 and 2009 (dollars in millions):

|              | <b>Three Months Ended</b> |             |
|--------------|---------------------------|-------------|
|              | <b>March 31,</b>          |             |
|              | <b>2010</b>               | <b>2009</b> |
| Net revenues | \$ 71.5                   | \$ 40.3     |
| Gross profit | \$ 35.9                   | \$ 20.9     |
| Gross margin | 50.2%                     | 52.0%       |

The decrease in our gross margin in the first quarter of 2010 compared to the same period in 2009 was driven primarily by lower royalty revenues from the expiration of our royalty agreement with Panasonic in June 2009, which accounted for 1.0% of the decline, and increased sales of recently introduced products, which tend to have a lower gross margin than earlier-generation products, and a stronger Japanese yen compared to the U.S. dollar, which collectively accounted for the remaining 0.8% of the decline.

*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 months ended March 31, 2010 and 2009 (dollars in millions):

|                                    | <b>Three Months Ended</b> |             |
|------------------------------------|---------------------------|-------------|
|                                    | <b>March 31,</b>          |             |
|                                    | <b>2010</b>               | <b>2009</b> |
| Net revenues                       | \$ 71.5                   | \$ 40.3     |
| R&D expenses                       | \$ 8.1                    | \$ 7.7      |
| R&D expenses as a % of net revenue | 11.3%                     | 19.2%       |

R&D expenses increased in the first quarter of 2010 compared to the first quarter of 2009, driven primarily by increased payroll and related expenses as a result of increased headcount, as well as increased product and technology development expenses. These expenses were partially offset by decreased stock-based compensation expense in the first quarter of 2010, as a result of a modification of our employee stock purchase plan (see Overview above). The modification resulted in \$0.8 million in stock-based compensation expenses in the first quarter of 2009 that would otherwise have been recognized in future quarters. Total stock-based compensation expense in the first quarter of 2010 was \$0.7 million compared to \$1.8 million in the first quarter of 2009.

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We expect our R&D expenses to increase in future periods as a result of the pending acquisition described in Note 15 to our condensed consolidated financial statements above. We believe the acquisition will result in additional annual R&D expenses of \$3.0 million to \$3.5 million beginning in the third quarter of 2010; a portion of these expenses will be non-cash amortization of intangible assets.

*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 months ended March 31, 2010 and 2009 (dollars in millions):

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2010</b>                             | <b>2009</b> |
| Net revenues                                       | \$ 71.5                                 | \$ 40.3     |
| Sales and marketing expenses                       | \$ 6.9                                  | \$ 6.2      |
| Sales and marketing expenses as a % of net revenue | 9.7%                                    | 15.4%       |

The increase in sales and marketing expenses in the first quarter of 2010 compared to the first quarter of 2009 was driven primarily by increased payroll and related expenses as a result of increased headcount, in addition to higher commission expenses resulting from increased revenues. The increase was partially offset by lower stock-based compensation expenses in the first quarter of 2010 as a result of the modification of our employee stock purchase plan, which resulted in \$0.4 million in stock-based compensation expenses in the first quarter of 2009 that would otherwise have been recognized in future quarters. Stock-based compensation expense in the first quarter of 2010 was \$0.4 million compared to \$1.0 million in the first quarter of 2009.

*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 months ended March 31, 2010 and 2009 (dollars in millions):

|                                    | <b>Three Months Ended<br/>March 31,</b> |             |
|------------------------------------|---|-------------|
|                                    | <b>2010</b>                             | <b>2009</b> |
| Net revenues                       | \$ 71.5                                 | \$ 40.3     |
| G&A expenses                       | \$ 6.0                                  | \$ 5.7      |
| G&A expenses as a % of net revenue | 8.4%                                    | 14.1%       |

G&A expenses increased period-over-period as a result of increased legal expenses of \$0.4 million related to patent litigation and acquisition activity, increased payroll related expenses of \$0.1 million due primarily to payroll taxes due to option exercises, and increased consulting expenses of \$0.1 million. These increases were partially offset by lower stock-based compensation expense in the first quarter of 2010 as a result of the modification of our employee stock purchase plan, which resulted in \$0.3 million in stock-based compensation expenses in the first quarter of 2009 that would otherwise have been recognized in future quarters. Stock-based compensation expense in the first quarter of 2010 was \$0.7 million compared to \$1.0 million in the first quarter of 2009.

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*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 months ended March 31, 2010 and 2009 (dollars in millions):

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2010</b>               | <b>2009</b> |
| Net revenues                            | \$ 71.5                   | \$ 40.3     |
| Other income, net                       | \$ 0.5                    | \$ 0.8      |
| Other income, net as a % of net revenue | 0.7%                      | 2.0%        |

Other income, net, for the first quarter of 2010 was \$0.5 million compared to \$0.8 million for the same period in 2009. The reduction was driven by a decrease in interest income reflecting a decrease in interest rates earned on cash and investment balances.

*Provision for income taxes.* Provision for income taxes represents federal, state and foreign taxes. The table below compares income tax expenses for the three months ended March 31, 2010 and 2009 (dollars in millions):

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> |
| Income before provision for income taxes | \$ 15.4                   | \$ 2.1      |
| Provision for income taxes               | \$ 3.1                    | \$ 1.7      |
| Effective tax rate                       | 19.9%                     | 81.0%       |

The provision for income taxes was \$3.1 million for the quarter ended March 31, 2010 compared to \$1.7 million for the quarter ended March 31, 2009. Our effective tax rates for the three months ended March 31, 2010 and 2009 were 20% and 81%, respectively. The difference between the expected statutory rate of 35% and our effective tax rate for the first quarter of 2010 was primarily due to the favorable impact from the geographic distribution of our world-wide earnings partially offset by a valuation allowance on our California deferred tax asset. The difference between the expected statutory rate of 35% and our effective tax rate for the first quarter of 2009 was primarily due to California budget legislation which resulted in the Company reducing the value of its state deferred tax assets by \$0.3 million and recording an income tax provision of \$0.8 million to establish a valuation allowance to reserve previously recorded net tax benefits from California tax credits. This was partially offset by the geographic distribution of our world-wide earnings.

**Liquidity and Capital Resources**

As of March 31, 2010, we had \$210.2 million in cash, cash equivalents and short-term and long-term investments (including \$0.3 million of restricted cash), an increase of approximately \$14.3 million from \$195.9 million as of December 31, 2009. As of March 31, 2010, we had working capital, defined as current assets less current liabilities, of \$175.0 million, a decrease of approximately \$5.0 million from \$180.0 million as of December 31, 2009.

Our operating activities generated cash of \$16.8 million in the three months ended March 31, 2010, driven primarily by i) net income of \$12.3 million, which included the impact of non-cash depreciation and amortization expenses and stock-based compensation expenses totaling \$2.9 million and \$2.0 million, respectively, ii) an increase in accounts payable of \$6.3 million related to increased production demand and iii) increased deferred income on sales to distributors of \$2.9 million related to increased shipments in the first quarter of 2010 compared to the prior quarter. These sources of cash were partially offset by i) an increase in accounts receivable of \$5.8 million, related to increased customer shipments and ii) increased inventory of \$5.2 million to accommodate the increase in demand.

Our operating activities generated cash of \$1.8 million in the three months ended March 31, 2009, driven primarily by net income of \$0.4 million, which included the impact of non-cash depreciation and amortization expenses and stock-based compensation expenses totaling \$2.5 million and \$4.0 million, respectively. These sources of cash were partially offset by an increase in accounts receivable, which resulted in a \$5.0 million use of cash. The increase in accounts receivable primarily reflected the timing of sales, as sales strengthened in the latter part of the quarter ended March 31, 2009.





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Our investing activities in the three months ended March 31, 2010 resulted in a \$29.5 million use of cash, consisting of \$24.4 million of net purchases of held-to-maturity investments, \$3.4 million for purchases of property and equipment, and \$1.8 million as an advance to purchase the assets of an early-stage research and development company which we intend to acquire (see Note 15 related to our definitive agreement). Our investing activities in the three months ended March 31, 2009 consisted primarily of net expenditures of \$1.5 million, consisting of \$1.8 million for purchases of property and equipment, partially offset by net proceeds of \$0.2 million on the sale of held-to-maturity investments.

In the three months ended March 31, 2010, we received \$3.0 million, net, from financing activities. We received \$10.0 million from the issuance of common stock, including \$8.3 million from the exercise of employee stock options, and \$1.7 million from the issuance of shares through our employee stock purchase plan. These receipts were partially offset by the use of \$6.0 million for the repurchase of our common stock, \$1.4 million for the payment of dividends to stockholders and \$0.8 million for the repurchase and retirement of shares related to employee income tax withholding.

We intend to pay dividends on a quarterly basis through the end of 2010, which are expected to result in a similar use of cash for each of the next three quarters. 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.

On May 14, 2009, we announced that our board of directors had authorized the use of up to \$25 million for the repurchase of shares of our common stock. From May 14, 2009 to December 31, 2009, we purchased 496,468 shares of our common stock for approximately \$11.0 million. In the first quarter of 2010 we purchased 170,774 shares of our common stock for approximately \$6.1 million (including fees), and as of March 31, 2010, there was approximately \$7.9 million remaining for future repurchases (including fees).

We used \$23.2 million for financing activities in the three months ended March 31, 2009. In October 2008 our board authorized \$50.0 million to be used for the repurchase of our common stock. In the three months ended March 31, 2009 we purchased 906,390 shares for \$17.6 million, concluding this repurchase program. Cash used for financing activities also included \$9.0 million for payments to employees for a tender offer announced in December 2008, and the use of \$0.7 million for the payment of dividends to stockholders. Offsetting these uses of cash were receipts of approximately \$4.1 million for the issuance of common stock through the exercise of stock options and purchases through our employee stock purchase plan.

As of March 31, 2010, we had contingent tax liabilities of \$25.1 million, compared to \$23.9 million as of December 31, 2009. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next twelve months. We will continue to accrue for uncertain tax positions during 2010 using the effective tax rate.

There were no material changes 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, 2009.

Our restricted cash balance of \$0.3 million at March 31, 2010 consisted of an interest-bearing certificate of deposit at the Union Bank of California. We entered into a security agreement with the bank, whereby the bank agreed to maintain \$0.3 million in an interest-bearing certificate of deposit. The certificate of deposit is restricted based on the bank's requirement that we maintain a restricted cash account in order to secure commercial letters of credit or standby letters of credit up to the deposit amount. As of March 31, 2010, there were two outstanding letters of credit totaling approximately \$0.2 million. This CD agreement remains in effect until cancellation of our letters of credit.

If our operating results deteriorate during the remainder of 2010, 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, or seek 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.

**Table of Contents****Recent Accounting Pronouncements**

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 are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of these provisions of ASU No. 2010-06 did not have a material impact on our consolidated financial statements. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements is effective for interim and annual reporting periods beginning after December 15, 2010. We do not expect the adoption of the remaining provisions of this ASU to have a material impact on our condensed consolidated financial statements.

On January 1, 2010, we adopted the following accounting pronouncement:

In December 2008, the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) issued ASC 715-20 (Formerly FASB staff position, or FSP, 132(R)-1, *Employer's Disclosures about Postretirement Benefit Plan Assets*). ASC 715-20 requires additional disclosures about assets held in an employer's defined benefit pension or other postretirement plan. This guidance is effective for fiscal years ending after December 15, 2009 and was adopted by us in 2010. There was no material impact to our condensed consolidated financial statements as a result of the adoption of this guidance.

**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 2009 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 twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months 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 March 31, 2010 and December 31, 2009, we held primarily cash equivalents and short-term and long-term investments with fixed interest rates.

*Foreign Currency Exchange Risk.* We transact business in various foreign countries. Our primary foreign currency cash flows are in Asia and Western Europe and involve a contract with one of our suppliers, OKI. Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts; however, the contract prices to purchase wafers from OKI are denominated in Japanese yen and the agreement allows for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. The purchase price is fixed at a base rate and allows for some sharing of the impact of exchange rate fluctuations from the base rate. One of our other major suppliers, Epson, contracts prices to purchase wafers in U.S. dollars, however; the agreement with Epson also allows for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S.

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dollar. Each year, our management and Epson agree to a fixed exchange rate. Nevertheless, changes in the exchange rate between the U.S. dollar and the Japanese yen could subject our gross profit and operating results to the potential for material fluctuations.

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, as amended (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 management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures include components of our internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within our disclosure controls and procedures, they are included in the scope of our periodic controls evaluation. 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 Securities Exchange Act of 1934, as amended, (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 March 31, 2010, which materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On October 20, 2004, we 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 our complaint, we alleged that Fairchild has and is infringing four of our patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any of our patents and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to us. 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 us finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding \$33,981,781 in damages. Although the jury awarded damages, at this stage of the proceedings we cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in our consolidated financial

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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 our 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 we 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 \$6,116,720, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying our 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. 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 at the end of July. The Court will now consider the issue of willfulness and issue a ruling.

On May 9, 2005, we 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). We filed a supplement to the complaint on May 24, 2005. We alleged infringement of our 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 our complaint. SG Corporation filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. We subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (ALJ) from January 18 to January 24, 2006. Post-hearing briefs were submitted and briefing concluded February 24, 2006. The ALJ's initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. After further briefing, on June 30, 2006 the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing SG PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing SG chip. The U.S. Customs Service is authorized to enforce the exclusion order. On October 11, 2006, the presidential review period expired without any action from the President, and the ITC exclusion order is now in full effect. SG appealed the ITC decision, and on November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects. On October 27, 2008, SG filed a petition to modify the exclusion order in view of a recent Federal Circuit opinion in an unrelated case, and we 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 June 14, 2007, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against Shanghai SIM-BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. sister corporation, BCD Semiconductor Corporation (referred to collectively as BCD). Our complaint alleged that certain integrated circuits produced by BCD infringe certain of our patents, seeking, among other things, an order enjoining BCD from infringing on our patents and an award for damages resulting from the alleged infringement. We voluntarily dismissed the California case against BCD on October 15, 2007 and filed a substantially identical complaint against BCD in the United States District Court for the District of Delaware on October 15, 2007. On January 21, 2008, BCD moved to dismiss the Delaware action for lack of personal jurisdiction in favor of a declaratory judgment action it filed against us on the same patents in the U.S. District Court, Northern District of California, discussed in further detail below. On September 9, 2008, the Court denied BCD's motion to dismiss, and BCD

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thereafter dismissed its separate declaratory judgment action and answered our complaint on September 19, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any of our patents and that the patents are invalid and unenforceable. The parties held a mediation session with the Court on January 30, 2009 and subsequently entered into a settlement agreement in February 2009. Pursuant to the settlement agreement, the Court entered an order prohibiting BCD from manufacturing or selling the products involved in the lawsuit in the United States or from selling such products for use in end products destined for the U.S. market.

On May 23, 2008, we 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 our complaint, we alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered our complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any of our patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing us 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 us, also in Delaware, which Fairchild dismissed in favor of adding its claims to our already pending suit against Fairchild. We 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 we filed our 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 case between the parties pending the entry of final judgment in that case. We have challenged the Court's stay order with respect to products already found to infringe in the other case, and the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of us 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 case is currently set for trial to begin on October 4, 2010.

On June 28, 2004, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (SG), a Taiwanese company, and its U.S. subsidiary. Our complaint alleged that certain integrated circuits produced by SG infringed and continue to infringe certain of our 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, we re-filed our complaint for patent infringement against SG and its parent corporations, Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation, to address their continued infringement of three of the patents at issue in the original suit that recently emerged from SG requested reexamination proceedings before the U.S. Patent and Trademark Office (USPTO). We seek, among other things, an order enjoining Fairchild and SG from infringing our patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integration patent, that the patents are invalid, and that two of the patents are unenforceable. The Court set a schedule for the case with claim construction proceedings beginning this summer and a further case management conference in September. On May 5, 2010, Fairchild and SG filed an amended answer including counterclaims accusing us of infringing two patents; we are evaluating these new claims and intend to contest them vigorously.

In February, 2010, Fairchild and System General (SG) filed suits for patent infringement against our subsidiary, 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. Power Integrations

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Netherlands and its representative offices have filed jurisdictional challenges to the proceedings, which 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 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). We believe the Fairchild and SG claims are without merit and intend to contest them vigorously.

In 2009, the IRS completed its audit of our 2002 and 2003 tax returns. We and the IRS were unable to reach an agreement on the adjustment it proposed for those years with respect to our research and development cost-sharing arrangement. We agreed to rollover this disputed issue into the audit of our tax returns for fiscal years 2004 through 2006 which is now in progress, in order to allow the IRS to further evaluate multiple year data related to our research and development cost-sharing arrangement.

On July 4, 2008 Azzurri Technology GmbH (in the following referred to as Azzurri) filed a complaint in the amount of EUR 1,247,832.07 plus interest against us in the Regional Court Munich I (Germany). This complaint was received by us on or about September 16, 2008. In its complaint, Azzurri, a former distributor and agent of our products in Germany and Austria, alleged that pursuant to mandatory European law it is entitled to a compensation claim in said amount following the termination of the distributor agreement by us even though the distribution agreement did not provide for such payment. In its written pleading we have denied such claims. In the meantime, however, the parties have entered into a settlement agreement; with a written pleading dated March 26, 2010 Azzurri has therefore withdrawn its claim. With a written pleading dated April 14, 2010 we have informed the Regional Court Munich I that we accept the claim withdrawal. The terms of this settlement agreement have no material impact on our financial statements.

There can be no assurance that we will prevail in the litigation with Fairchild. This litigation, whether or not determined in our favor or settled, will be costly and will divert the efforts and attention of our management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. In addition, we are unable to predict the outcome of the other legal proceedings and matters described above. Adverse determinations in litigation could result in monetary losses, the loss of proprietary rights, subject us to significant liabilities, and require us to seek licenses from third parties or prevent us from licensing the technology, any of which could have a material adverse effect on our business, financial condition and operating results.

We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of business. These matters are subject to inherent uncertainties and our view of these matters may change in the future and could result in charges that would have a material adverse impact on our financial position, results of operations, or cash flows.

**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, 2009, except that one risk factor contained in our Annual Report on Form 10-K did not appear below as we no longer consider this risk material.*

*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.*

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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;

we are being audited by the Internal Revenue Service, which is asserting that we owe additional taxes relating to a number of items;

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;

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 litigation against Fairchild Semiconductor and others;

the lengthy timing of our sales cycle;

undetected defects and failures in meeting the exact specifications required by our products;

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;

the ability of our products to penetrate additional markets;

attraction and retention of qualified personnel;



changes in environmental laws and regulations, including with respect to energy consumption and climate change; 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 60% and 62% of our net revenues for the three months ended March 31, 2010 and the year ended December 31, 2009, 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.

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*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 2010 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 OKI, XFAB and Epson. Our contracts with these suppliers expire in April 2018, December 2012 and December 2010, respectively. Although certain aspects of our relationships with OKI (purchased by Rohm Co. of Japan as of October 1, 2008), XFAB and Epson are contractual, many important aspects of these relationships depend on their continued cooperation. We cannot assure that we will continue to work successfully with OKI, XFAB 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 OKI, XFAB 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 adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

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In addition, if prices for commodities used in our products increase significantly, raw materials 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, which is used in our IC packages, 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.

*We are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of items, and if we are not successful in defending our position 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 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, which are currently under audit. While the IRS has not completed its audit for these years, we anticipate that it will again propose an adjustment related to our research and development cost-sharing arrangement. Resolution of this matter could take considerable time, possibly years.

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.

*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.* The contract prices to purchase wafers from OKI are denominated in Japanese yen, and the contract prices to purchase wafers from Epson is denominated in U.S. dollars. The agreements with these vendors allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Nevertheless, changes in the exchange rate between the U.S. dollar and the Japanese yen could subject our gross profit and operating results to the potential for material fluctuations.

*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.

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Additionally, because these laws, regulations and standards promulgated by the Sarbanes-Oxley Act are 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 against Fairchild Semiconductor and System General, 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 involved in patent litigation with Fairchild Semiconductor and its wholly-owned subsidiary, System General, and the outcome of this litigation is uncertain. See Part II, Item 1, Legal Proceedings. While Fairchild has been found to infringe four of our patents and those patents have been found valid by a jury and enforceable by the Court, there can be no assurance that we will be successful in obtaining financial damages or injunctive relief against infringing products. Moreover, should we ultimately lose on Fairchild and System General's counterclaims for patent infringement, or if an injunction is issued against us while an appeal 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, 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 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 95% of our net revenues for both the quarter ended March 31, 2010 and 2009. 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;

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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 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, 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. Although we maintain reserves for potential customer returns, 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.

*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.

*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.

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*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 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. Many of our suppliers are also susceptible to other disasters such as tropical storms, typhoons or tsunamis. In the event of a disaster, 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 at our facilities could delay the development and shipment of our products.

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**

| <b>Period</b>                   | <b>Total Number of Shares Purchased (1)</b> | <b>Average Price Paid Per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Maximum Dollar Value of Shares that May Yet be Repurchased Under the Plans or Programs (in millions)(2)</b> |
|---------------------------------|---|-------------------------------------|---|--|
| January 1 to January 31, 2010   |   | \$                                  |   | \$ 14.0  |
| February 1 to February 28, 2010 | 194,166                                     | \$ 35.03                            | 170,774   | \$ 7.9   |
| March 1 to March 31, 2010       |   | \$                                  |   | \$ 7.9   |
| <b>Total</b>                    | <b>194,166</b>                              |                                     | <b>170,774</b>  |  |

- (1) In February 2010, we purchased and retired 23,392 shares, which totaled \$0.8 million, of common stock from our executives for income tax withholding.
- (2) On May 14, 2009, we announced that our board of directors had authorized the use of up to \$25 million for the repurchase of shares of our common stock. From May 14, 2009 to December 31, 2009, we purchased 496,468 shares of our common stock for approximately \$11.0 million. In the first quarter of 2010 we purchased 170,774 shares of our common stock for approximately \$6.1 million (including fees), and as of March 31, 2010, there was approximately \$7.9 million (including fees) remaining for future repurchases. Currently there is no expiration date for this stock repurchase plan.

## 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: May 6, 2010

By: /s/ BILL ROESCHLEIN  
Bill Roeschlein  
Chief Financial Officer (Principal Financial and  
Accounting Officer)

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**INDEX TO EXHIBITS**

| <b>EXHIBIT NUMBER</b> | <b>DESCRIPTION</b>  |
|-----------------------|---|
| 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                   | Form of Certificate of Designation, Preferences and Rights of the Terms of the Series A Preferred Stock filed as Exhibit A to the Form of Rights Agreement between us and BankBoston N.A., dated February 24, 1999. (As filed with the SEC as Exhibit 1 to our Current Report on Form 8-K on March 12, 1999, SEC File No. 000-23441.) |
| 3.4                   | 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.)  |
| 3.5                   | 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 3.5.   |
| 10.1                  | Form of Restricted Stock Unit Grant Notice and Form of Restricted Stock Unit Award Agreement.   |
| 10.2                  | Amendment No. 2 to the Power Integrations, Inc. 1997 Outside Directors Stock Option Plan, effective as of April 12, 2010.   |
| 10.3                  | 2010 Executive Compensation Arrangements (Described under Item 5.02 of our Current Reports on Form 8-K, as filed with the SEC on February 5, 2010 and April 16, 2010, SEC File No. 000-23441.)  |
| 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.**   |

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

\*\* The certifications attached as Exhibits 32.1 and 32.2 accompany this Form 10-Q, are not deemed filed with the SEC, and are not to be incorporated by reference into an 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.