

POWER INTEGRATIONS INC  
Form 10-Q  
May 05, 2011  
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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, 2011

or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from            to

Commission File Number 0-23441

**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
Common Stock, \$.001 par value

Outstanding at April 20, 2011
28,836,405 shares

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**POWER INTEGRATIONS, INC.**

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**Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words would, could, will, may, expect, believe, should, anticipate, out, intend, plan, estimate, predict, potential, targets, seek or continue and similar words and phrases, including the negatives of these terms and variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under Item 1A of Part II Risk Factors, Item 2 of Part I Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Quarterly Report on Form 10-Q, including: our ability to maintain and establish strategic relationships; the risks inherent in the development and delivery of complex technologies; our ability to attract, retain and motivate qualified personnel; the emergence of new markets for our products and services; our ability to compete in those markets based on timeliness, cost and market demand; and our ability to procure on reasonable terms an adequate and timely supply of our products from third party manufacturers. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we have no obligation (and expressly disclaim any such obligation) to update or alter any forward-looking statements, whether as a result of new information or otherwise except as otherwise required by securities regulations.

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

## ITEM 1. FINANCIAL STATEMENTS

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

	March 31, 2011	December 31, 2010
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 137,694	\$ 155,667
Short-term investments	32,070	27,355
Accounts receivable, net of allowance of \$297 and \$275 in 2011 and 2010	13,314	5,713
Inventories	63,004	62,077
Deferred tax assets	1,434	1,435
Prepaid expenses and other current assets	8,217	9,263
<b>Total current assets</b>	<b>255,733</b>	<b>261,510</b>
LONG-TERM INVESTMENTS	36,815	31,760
PROPERTY AND EQUIPMENT, net	84,586	84,470
INTANGIBLE ASSETS, net	9,552	9,795
GOODWILL	14,826	14,826
DEFERRED TAX ASSETS	13,022	13,421
OTHER ASSETS	22,439	17,288
<b>Total assets</b>	<b>\$ 436,973</b>	<b>\$ 433,070</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 13,932	\$ 20,291
Accrued payroll and related expenses	5,455	7,395
Deferred income on sales to distributors	10,951	12,221
Other accrued liabilities	2,918	9,548
<b>Total current liabilities</b>	<b>33,256</b>	<b>49,455</b>
LONG-TERM INCOME TAXES PAYABLE	30,676	29,580
<b>Total liabilities</b>	<b>63,932</b>	<b>79,035</b>
<b>COMMITMENTS AND CONTINGENCIES (Note 9, 11 and 12)</b>		
<b>STOCKHOLDERS EQUITY:</b>		
Common stock	29	28
Additional paid-in capital	185,834	175,295
Accumulated other comprehensive income	135	85

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Retained earnings	187,043	178,627
Total stockholders' equity	373,041	354,035
Total liabilities and stockholders' equity	\$ 436,973	\$ 433,070

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 Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
NET REVENUES	\$ 76,762	\$ 71,507
COST OF REVENUES	40,339	35,585
<b>GROSS PROFIT</b>	<b>36,423</b>	<b>35,922</b>
OPERATING EXPENSES:		
Research and development	10,023	8,111
Sales and marketing	8,248	6,920
General and administrative	6,475	6,013
Total operating expenses	24,746	21,044
<b>INCOME FROM OPERATIONS</b>	<b>11,677</b>	<b>14,878</b>
OTHER INCOME, NET	442	494
<b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>	<b>12,119</b>	<b>15,372</b>
PROVISION FOR INCOME TAXES	2,265	3,058
<b>NET INCOME</b>	<b>\$ 9,854</b>	<b>\$ 12,314</b>
EARNINGS PER SHARE:		
Basic	\$ 0.34	\$ 0.45
Diluted	\$ 0.33	\$ 0.42
SHARES USED IN PER SHARE CALCULATION:		
Basic	28,628	27,470
Diluted	30,187	29,358

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 March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 9,854	\$ 12,314
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,682	2,761
Amortization of intangibles	243	172
Stock-based compensation expense	2,504	2,027
Amortization of premium on held to maturity investments	439	350
Loss on sale of property and equipment		13
Deferred income taxes	399	1,498
Increase in allowances - accounts receivable and other	22	
Excess tax benefit from stock options exercised	(398)	(1,176)
Tax benefit associated with employee stock plans	783	2,535
Change in operating assets and liabilities:		
Accounts receivable	(7,622)	(5,830)
Inventories	(964)	(5,185)
Prepaid expenses and other current assets	1,435	(672)
Accounts payable	(2,908)	6,295
Income taxes payable and accrued liabilities	(525)	(1,200)
Deferred income on sales to distributors	(1,269)	2,877
Net cash provided by operating activities	5,675	16,779
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(7,248)	(3,360)
Acquisition of a business	(6,901)	
Advance for acquisition of a business		(1,750)
Increase in financing lease receivables	(5,642)	
Collections of financing lease receivable	102	
Purchases of held-to-maturity investments	(11,508)	(27,224)
Proceeds from maturities of held-to-maturity investments	1,300	2,850
Net cash used in investing activities	(29,897)	(29,484)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock under employee stock plans	7,288	10,035
Repurchase of common stock		(6,038)
Retirement of shares for income tax withholding		(769)
Excess tax benefit from stock options exercised	398	1,176
Payments of dividends to stockholders	(1,437)	(1,378)
Net cash provided by financing activities	6,249	3,026
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(17,973)</b>	<b>(9,679)</b>



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CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	155,667	134,974
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 137,694	\$ 125,295
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unpaid property and equipment, net	\$ 1,917	\$ 2,918
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for income taxes, net of refunds	\$ 118	\$ 16

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, 2010 included in its Form 10-K filed on February 25, 2011 with the Securities and Exchange Commission.

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

*Cash and Cash Equivalents*

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

*Short-Term and Long-Term Investments*

Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of March 31, 2011 and December 31, 2010, the Company's short-term and long-term investments consisted of U.S. government backed securities, municipal bonds, corporate commercial paper 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.

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

Amortized cost and estimated fair market value of short-term and long-term investments classified as held-to-maturity at March 31, 2011, are as follows (in thousands):

	Amortized Cost	Gross Unrealized		Estimated Fair Market Value
		Gains	Losses	
<b>Investments due in less than 3 months:</b>				
Corporate securities	\$ 5,356	\$ 4	\$	\$ 5,360
<b>Total</b>	<b>\$ 5,356</b>	<b>\$ 4</b>	<b>\$</b>	<b>\$ 5,360</b>
<b>Investments due in 4-12 months:</b>				
Corporate securities	\$ 20,650	\$ 144	\$	\$ 20,794
U.S. government securities	5,061	18		5,079
U.S. municipal securities	1,003	1		1,004
<b>Total</b>	<b>\$ 26,714</b>	<b>\$ 163</b>	<b>\$</b>	<b>\$ 26,877</b>
<b>Investments due in more than 12 months:</b>				
Corporate securities	\$ 36,815	\$ 577	\$ (7)	\$ 37,385
<b>Total</b>	<b>\$ 36,815</b>	<b>\$ 577</b>	<b>\$ (7)</b>	<b>\$ 37,385</b>
Total investment securities	\$ 68,885	\$ 744	\$ (7)	\$ 69,622

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

	Amortized Cost	Gross Unrealized		Estimated Fair Market Value
		Gains	Losses	
<b>Investments due in less than 3 months:</b>				
Commercial paper	\$ 7,135	\$	\$	\$ 7,135
Corporate securities	1,508		(1)	1,507
<b>Total</b>	<b>\$ 8,643</b>	<b>\$</b>	<b>\$ (1)</b>	<b>\$ 8,642</b>
<b>Investments due in 4-12 months:</b>				
Corporate securities	\$ 21,255	\$ 84	\$	\$ 21,339
U.S. government securities	5,095	20		5,115

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U.S. municipal securities	1,005	3		1,008
<b>Total</b>	<b>\$ 27,355</b>	<b>\$ 107</b>	<b>\$</b>	<b>\$ 27,462</b>
<b>Investments due in more than 12 months:</b>				
Corporate securities	\$ 31,760	\$ 648	\$	\$ 32,408
<b>Total</b>	<b>\$ 31,760</b>	<b>\$ 648</b>	<b>\$</b>	<b>\$ 32,408</b>
<b>Total investment securities</b>	<b>\$ 67,758</b>	<b>\$ 755</b>	<b>\$ (1)</b>	<b>\$ 68,512</b>

*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

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

arrival of the product in that country. Shipping terms to international OEMs and merchant power supply manufacturers on shipments from the Company's facility outside of the United States are EX Works (EXW), meaning that title to the product transfers to the customer upon shipment from the Company's foreign warehouse. Shipments to OEMs and merchant power supply manufacturers in the Americas are free on board (FOB) point of origin meaning that title is passed to the customer upon shipment. Revenue is recognized upon title transfer for sales to OEMs and merchant power supply manufacturers, assuming all other criteria for revenue recognition are met as described below.

The Company applies the provisions of Accounting Standard Codification (ASC) 605-10 (ASC 605-10) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the customer. The Company considers the price to be fixed based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary.

The Company makes sales to distributors and retail partners and recognizes revenue based on a sell-through method. Sales to distributors are made under terms allowing certain 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, 2011 and December 31, 2010 was approximately \$23.1 million and \$24.7 million, respectively. The total deferred cost as of March 31, 2011 and December 31, 2010 was approximately \$12.2 million and \$12.5 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, Stock Repurchases and Common Stock Dividend*

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, and in the first two quarters of 2010 the Company purchased 0.4 million shares for approximately \$14.0 million, concluding this repurchase program.

In February 2011, the board of directors authorized the use of an additional \$50 million for the repurchase of the Company's common stock. Repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors; the guidelines do not provide for repurchases at current stock price levels. There is no expiration date for this stock repurchase program.

In January 2010, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2010. The quarterly dividend payments were made on March 31, 2010, June 30, 2010, September 30, 2010 and December 31, 2010, to stockholders of record as of February 26, 2010, May 28, 2010, August 31, 2010 and November 30, 2010, respectively, each in the aggregate amount of approximately \$1.4 million.

In October 2010, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2011. The first quarterly dividend payment of approximately \$1.4 million was made on March 31, 2011, to stockholders of record as of February 28, 2011. The Company expects that each of the remaining quarterly dividends will result in a similar use of cash. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the Company's stockholders.



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

The Company applies the provisions of ASC 718-10. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award.

*Determining Fair Value of Stock Options*

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

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

*Expected Term.* The Company 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 model on the implied yield available on a U.S. Treasury note with a term approximately equal to the expected term of the underlying grants.

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

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

*Use of Estimates*

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

*Comprehensive Income*

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

	Three Months Ended March 31,	
	2011	2010
Net income	\$ 9,854	\$ 12,314
Other comprehensive income:		
Translation adjustments	50	(50)
Total comprehensive income	\$ 9,904	\$ 12,264





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

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Accounts receivable trade	\$ 38,298	\$ 30,656
Accrued ship and debit and rebate claims	(24,688)	(24,839)
Allowance for doubtful accounts	(297)	(275)
Other	1	171
<b>Total</b>	<b>\$ 13,314</b>	<b>\$ 5,713</b>

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

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Prepaid legal fees	\$ 3,000	\$ 4,000
Prepaid inventory (Note 16)	346	917
Prepaid income tax	1,249	1,117
Prepaid maintenance agreements	554	554
Interest receivable	696	737
Other	2,372	1,938
<b>Total</b>	<b>\$ 8,217</b>	<b>\$ 9,263</b>

*Other Assets (in thousands)*

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Prepaid royalty (Note 15)	\$ 10,000	\$ 10,000
Investment in third party (Note 15)	7,000	7,000
Financing lease receivables and deposits (Note 17)	5,119	5,119
Other	320	288
<b>Total</b>	<b>\$ 22,439</b>	<b>\$ 17,288</b>

*Other Accrued Liabilities (in thousands):*

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	March 31, 2011	December 31, 2010
Accrued payment for acquisition (Note 14)	\$ 53	\$ 6,955
Accrued professional fees	1,418	1,013
Accrued expense for engineering wafers	511	502
Advances from customers	535	713
Other	401	365
Total	\$ 2,918	\$ 9,548

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

*Segment Reporting*

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

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

**Stock Plans**

As of March 31, 2011, 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 (RSUs), stock appreciation rights, performance stock awards and other stock awards to employees, directors and consultants. As of March 31, 2011, the maximum remaining number of shares that may be issued under the 2007 Plan was 7,238,954 shares, which consists of the shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options and stock awards under the 1997 Plan. Pursuant to the 2007 Plan, the exercise price for incentive stock options and nonstatutory stock options is generally at least 100% of the fair market value of the underlying shares on the date of grant. Options generally vest over 48 months measured from the date of grant. Options generally expire no later than ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

Beginning January 27, 2009, grants pursuant to the Directors Equity Compensation Program (that was adopted by the board of directors on January 27, 2009) to nonemployee directors have been made primarily under the 2007 Plan. The Directors Equity Compensation Program provides in certain circumstances (depending on the status of the particular director's holdings of Company stock options) for the automatic grant of nonstatutory stock options to nonemployee directors of the Company on the first trading day of July in each year over their period of service on the board of directors. Further, each future nonemployee director of the Company would be granted under the 2007 Plan: (a) on the first trading day of the month following commencement of service, an option to purchase the number of shares of common stock equal to: the fraction of a year between the date of the director's appointment to the board of directors and the next July 1, multiplied by 8,000, which option shall vest on the next July 1<sup>st</sup>; and (b) on the first trading day of July following commencement of service, an option to purchase 24,000 shares vesting monthly over the three year period commencing on the grant date. The Directors Equity Compensation Program will remain in effect at the discretion of the board of directors or the compensation committee.

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

*1997 Stock Option Plan*

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the 1997 Plan), whereby the board of directors could grant incentive stock options and nonstatutory stock options to purchase the Company's common stock to key employees, directors and consultants. The exercise price of incentive stock options could not be less than 100% of the fair market value of the Company's common stock on the date of grant. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant.



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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

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

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

*1998 Nonstatutory Stock Option Plan*

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the 1998 Plan); whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to the extent that such options do not require approval of the Company's stockholders. The 1998 Plan has not been approved by the Company's stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. As of March 31, 2011, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000, and as of that date no shares are available for future issuance. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

On July 28, 2009, the 1998 Plan was amended generally to prohibit outstanding options from being amended 1) to reduce the exercise price of such outstanding options or 2) canceled in exchanged for cash, other awards or options with a lower exercise price without stockholder approval.

*1997 Employee Stock Purchase Plan*

Under the 1997 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee's compensation, to the purchase of shares of the Company's common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company's common stock on the first day of each offering period,



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or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of March 31, 2011, 2,287,552 shares had been purchased and 712,448 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. See Note 2, Summary of Significant Accounting Policies, for a description of the Company's assumptions used in the calculation of its share-based compensation expense. Changes in these estimates could result in changes to the Company's compensation charges.

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three months ended March 31, 2011 and March 31, 2010 (in thousands).

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Cost of revenues	\$ 239	\$ 157
Research and development	811	727
Sales and marketing	667	410
General and administrative	787	733
<b>Total</b>	<b>\$ 2,504</b>	<b>\$ 2,027</b>

As of March 31, 2011 there were approximately \$6.4 million, net of expected forfeitures, of total unrecognized compensation costs related to stock options. The unrecognized compensation costs at March 31, 2011 are expected to be recognized over a weighted-average period of 2.05 years.

As of March 31, 2011, the Company had \$2.4 million of total unrecognized compensation expense, net of estimated forfeitures, related to performance-based share grants. The unamortized compensation expense will be recognized on a straight-line basis, and is expected to be recognized over the remainder of 2011.

As of March 31, 2011, the Company had \$6.4 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock units. The unamortized compensation expense will be recognized on a straight-line basis, and is expected to be recognized over a weighted-average period of 3.14 years.

As of March 31, 2011, the total unrecognized compensation cost under the Purchase Plan to purchase the Company's common stock was approximately \$0.4 million. The Company will amortize this cost on a straight-line basis over approximately 0.5 years.

In the first quarter of 2011 a total of approximately \$2.5 million was recorded as stock-based compensation expense, which was comprised of approximately \$1.2 million related to stock options, \$0.3 million related to performance shares, \$0.6 million related to restricted stock units and

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\$0.3 million related to the Purchase Plan and approximately \$37,000 in compensation expense amortized from beginning inventory. In the first quarter of 2010 a total of approximately \$2.0 million was recorded as stock-based compensation expense, which 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.



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## POWER INTEGRATIONS, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The Company did not grant stock options in the first quarter of 2011 or 2010, and therefore no fair value assumptions were reported for those periods. The Company granted restricted stock units to new-hire employees in the first quarters of 2011 and 2010; see the *Restricted Stock Units* section below for details.

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	
	2011	2010
Risk-free interest rates	0.17%	0.17%
Expected volatility rates	37%	36%
Expected dividend yield	0.51%	0.55%
Expected term of purchase right (in years)	0.5	0.5
Weighted-average estimated fair value of purchase rights	\$ 9.40	\$ 7.96

A summary of stock option activity under the Plans, excluding performance-based shares and restricted stock units, as of March 31, 2011, and changes during the three months then ended, is presented below:

	Shares (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2011	4,433	\$ 22.68		
Granted				
Exercised	(277)	18.83		
Forfeited or expired	(44)	25.26		
Outstanding at March 31, 2011	4,112	\$ 22.91	4.73	\$ 63,385
Exercisable at March 31, 2011	3,395	\$ 22.53	3.99	\$ 53,652
Vested and expected to vest at March 31, 2011	4,075	\$ 22.87	4.69	\$ 62,993

The Company did not grant stock options in the three months ended March 31, 2011 and 2010; since 2010 the Company's equity grants to new hires and its annual incentive grants to non-executive employees have been primarily in the form of RSUs. The total intrinsic value of options exercised during the three months ended March 31, 2011 and 2010 was \$6.2 million and \$8.3 million, respectively.

*Performance-based Awards*

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

During the quarter ended March 31, 2011, the Company issued approximately 93,300 performance-based awards to employees and executives. As the net revenue and non-GAAP operating earnings are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, will be recorded throughout the year

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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.

In January 2011, it was determined that the Company had reached the maximum level of the established performance targets for the performance-based awards granted in 2010. Accordingly, the 85,150 performance-based awards, which were fully vested, were released to the Company's employees and executives in the first quarter of 2011.

A summary of performance-based awards outstanding as of March 31, 2011, and activity during the three months then ended, is presented below:

	Shares (in thousands)	Weighted- Average Grant Date Fair Value Per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2011	85	\$ 34.97		
Granted	93	36.90		
Vested	(85)	34.97		
Forfeited or expired	(6)	36.61		
Outstanding at March 31, 2011	87	\$ 36.93	0.75	\$ 3,331
Vested and expected to vest at March 31, 2011	82		0.75	\$ 3,146

The weighted average grant-date fair value per share of performance-based awards granted in the quarters ended March 31, 2011 and 2010 was approximately \$36.90 and \$32.07, respectively. The grant date fair value of awards released, which were fully vested, in the quarters ended March 31, 2011 and 2010 was approximately \$3.0 million and \$2.2 million, respectively.

*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 shares available for issuance under the 2007 Plan by 2 shares.

A summary of RSUs outstanding as of March 31, 2011, and changes during the three months then ended was as follows:

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	Shares (in thousands)	Weighted- Average Grant Date Fair Value Per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2011	260	\$ 36.30		
Granted	9	38.66		
Vested	(3)	37.09		
Forfeited or expired	(8)	37.29		
Outstanding at March 31, 2011	258	\$ 36.35	1.69	\$ 9,890
Vested and expected to vest at March 31, 2011	228		1.68	\$ 8,755

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The weighted-average grant-date fair value of RSUs awarded in the three months ended March 31, 2011 and 2010 was approximately \$38.66 and \$36.41, respectively. The grant date fair value of awards vested in the quarter ended March 31, 2011 was approximately \$0.1 million; there were no RSUs vested in the three months ended March 31, 2010.

**4. FAIR VALUE MEASUREMENTS**

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

The Company's cash and investment instruments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The type of instrument valued based on quoted market prices in active markets primarily includes money market securities. This type of instrument is generally classified within Level 1 of the fair value hierarchy. The types of instruments valued based on other observable inputs (Level 2 of the fair value hierarchy) include investment-grade corporate bonds, government, state, municipal and provincial obligations, and are valued by using a multi-dimensional relational model, the inputs, when available, are primarily benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data including market research publications. The Company's investments classified as Level 1 and Level 2 are held-to-maturity investments, and were valued using the amortized-cost method, which approximates fair market value.

On October 22, 2010, the Company entered into an agreement with SemiSouth Laboratories, pursuant to which, among other things, the Company may be obligated to acquire SemiSouth if SemiSouth meets certain financial performance conditions. At March 31, 2011, the Company determined the fair value of this potential obligation to be zero. The Company used Level 2 inputs in its fair market valuation using a market approach valuation technique and determined the fair value of this obligation to be zero. The Company derived the Level 2 inputs principally from corroborated observable market data (i.e., correlation values). The Company will update the fair value quarterly and record any changes to the consolidated financial statements.

The fair value hierarchy of the Company's marketable securities and investments for the periods ended March 31, 2011 and December 31, 2010, was as follows (in thousands):

Description	Balance at March 31, 2011	Fair Value Measurement at March 31, 2011:	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market accounts	\$ 40,354	\$ 40,354	\$
U.S. Government debt securities	6,064		6,064

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Corporate Securities	62,821		62,821
Total	\$ 109,239	\$ 40,354	\$ 68,885

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

The Company had no Level 3 investments as of the periods ended March 31, 2011 and December 31, 2010.

**5 INVENTORIES:**

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

	March 31, 2011	December 31, 2010
Raw materials	\$ 19,719	\$ 20,334
Work-in-process	13,703	13,171
Finished goods	29,582	28,572
<b>Total</b>	<b>\$ 63,004</b>	<b>\$ 62,077</b>

**6. GOODWILL AND INTANGIBLE ASSETS:**

The carrying amount of goodwill was \$14.8 million as of the periods ended March 31, 2011 and December 31, 2010.

Intangible assets consist primarily of acquired licenses, in-process research and development and patent rights, and are reported net of accumulated amortization. In the year ended December 31, 2010, the Company acquired an early-stage research and development company, resulting in the addition of in-process research and development of \$4.7 million, and the Company acquired Qspeed Semiconductor resulting in the addition of customer relationships of \$0.9 million, and developed technology of \$1.8 million (see Note 14). The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the acquired license or patent rights, which range from five to ten years, with the exception of \$4.7 million of in-process research and development which will be amortized once the development is

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completed and products are available for sale. Amortization for acquired intangible assets was approximately \$0.2 million in the first quarter of 2011 and 2010. The Company does not believe there is any significant residual value associated with the following intangible assets (in thousands):



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	March 31, 2011			December 31, 2010		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
In-process research and development	\$ 4,690	\$	\$ 4,690	\$ 4,690	\$	\$ 4,690
Technology licenses	3,000	(1,500)	1,500	3,000	(1,425)	1,575
Patent rights	1,949	(1,814)	135	1,949	(1,760)	189
Developed technology	2,920	(575)	2,345	2,920	(489)	2,431
Customer relationships	910	(28)	882	910		910
Other intangibles	37	(37)		37	(37)	
<b>Total intangible assets</b>	<b>\$ 13,506</b>	<b>\$ (3,954)</b>	<b>\$ 9,552</b>	<b>\$ 13,506</b>	<b>\$ (3,711)</b>	<b>\$ 9,795</b>

The estimated future amortization expense related to intangible assets at March 31, 2011 is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2011 (remaining 9 months)	\$ 700
2012	755
2013	755
2014	755
2015	592
Thereafter	1,305
<b>Total (1)</b>	<b>\$ 4,862</b>

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

**7. SIGNIFICANT CUSTOMER CONCENTRATIONS AND SALES INFORMATION:***Customer Concentration*

Ten customers accounted for approximately 67% and 60% of net revenues for the three months ended March 31, 2011 and March 31, 2010, respectively. A significant portion of these revenues are attributable to sales of the Company's products to distributors of electronic components. These distributors sell the Company's products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers. Two customers, both distributors of the Company's products, accounted for 19% and 12% of net revenues in the three months ended March 31, 2011. The same two customers accounted for 13% and 11% of net revenues in the three months ended March 31, 2010.

*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.

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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, 2011 and December 31, 2010, 77% and 76%, respectively, of accounts receivable were concentrated with the Company's top ten customers.

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The following customers represented 10% or more of accounts receivable:

<b>Customer</b>	<b>March 31, 2011</b>	<b>December 31, 2010</b>
A	19%	21%
B	18%	*

\* less than 10%

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

*International Sales*

The Company markets its products through its sales personnel and a worldwide network of distributors. As a 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, 2011</b>	<b>2010</b>
Hong Kong/China	34%	28%
Taiwan	24%	26%
Korea	17%	21%
Western Europe (excluding Germany)	10%	7%
Japan	6%	6%
Singapore	3%	2%
Germany	1%	3%
Other	1%	2%
<b>Total revenue, excluding the Americas.</b>	<b>96%</b>	<b>95%</b>

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.

*Product Sales*

Approximately 98% to 99% of the Company's sales in the three months ended March 31, 2011 and 2010 were from its three primary groupings of low-power AC-DC power-conversion products - TOPSwitch, TinySwitch and LinkSwitch. Approximately 1% to 2% of the Company's sales

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came from other product families, principally the Company's DPA-Switch family of high-voltage DC-DC products, and in the first quarter of 2011, the Company's Hiper family of products which includes both power-conversion and power-factor-correction products for high-power applications.

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Revenue mix by product grouping was as follows:

Product Family	Three Months Ended	
	March 31,	
	2011	2010
LinkSwitch	40%	36%
TinySwitch	35%	39%
TOPSwitch	23%	24%
Other	2%	1%

**8. EARNINGS PER SHARE:**

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

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

	Three Months Ended	
	March 31,	
	2011	2010
Basic earnings per share:		
Net income	\$ 9,854	\$ 12,314
Weighted-average common shares	28,628	27,470
Basic earnings per share	\$ 0.34	\$ 0.45
Diluted earnings per share (1):		
Net income	\$ 9,854	\$ 12,314
Weighted-average common shares	28,628	27,470
Effect of dilutive securities:		
Employee stock plans	1,559	1,888
Diluted weighted-average common shares	30,187	29,358
Diluted earnings per share	\$ 0.33	\$ 0.42

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

Outstanding options to purchase 210,044 shares and 86,462 shares of the Company's common stock for the quarters ended March 31, 2011 and 2010, respectively, were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive.

**9. INCOME TAXES:**

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

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In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income. The Company limits the deferred tax assets recognized related to certain highly-paid officers of the Company to amounts that it estimates will be deductible in future periods based upon the provisions of the Internal Revenue Code Section 162(m). In the event that the Company determines, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, the Company would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on its results of operations and financial position.

As of March 31, 2011, the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets as the Company believes that it is not more likely than not that the deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur. The Company's effective tax rates for the three months ended March 31, 2011 and 2010 were 18.7% and 19.9%, respectively. The difference between the expected statutory rate of 35.0% and the Company's effective tax rate for the three months ended March 31, 2011 was primarily due to the beneficial impact of the geographic distribution of the Company's world-wide earnings and the beneficial impact of the research and experimentation tax credit. The difference between the expected statutory rate of 35.0% and the Company's effective tax rate for the three months ended March 31, 2010 was primarily due to the beneficial impact of the geographic distribution of the Company's world-wide earnings partially offset by a valuation allowance on its California deferred tax assets.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. In the quarter ended March 31, 2011, the IRS informed the Company that the IRS intends to propose adjustments to the Company's taxable income for fiscal years 2003 through 2006 related to the Company's intercompany research and development cost-sharing arrangement and related issues. The Company believes that the IRS position is without merit and intends to defend its tax return position vigorously. The fiscal years 2007 through 2009 are also under audit by the IRS.

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

**10. INDEMNIFICATIONS:**

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





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**(unaudited)**

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, 2011. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

**11. COMMITMENTS AND CONTINGENCIES:**

From time to time in the ordinary course of business, the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company (see Note 12). In accordance with ASC 450-10, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

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. The agreement requires the wafer purchases to be in Japanese yen; however, the purchase price within these agreements 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 contracts prices to purchase wafers in U.S. dollars; however, the agreement also allows for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and this wafer supplier review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between both parties. The Company accounted for the gain or loss related to the payment of these transactions as part of other income or expense.

**12. 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, 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

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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 shortly thereafter. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents. The Court also invited briefing on enhanced damages and attorneys' fees, and Fairchild filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of \$12.9 million. Fairchild has filed a notice of appeal challenging the final judgment and a number of the underlying rulings.

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

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly-owned subsidiary System General Corporation (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.

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against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On February 10, 2011, the Court issued an order maintaining the stay with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case pending the appeal in that case. On April 18, 2011, the Court rescheduled the trial to begin in January 2012.

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

In February 2010, Fairchild and System General (SG) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The proceedings are still in their early stages, with no hearings or trial currently scheduled. The suits assert four Chinese patents and seek an injunction and damages of approximately \$17 million. Power Integrations Netherlands has filed invalidation

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**POWER INTEGRATIONS, INC.**

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

**(unaudited)**

proceedings for all four asserted SG patents in the People's Republic of China Patent Reexamination Board (PRB) of the State Intellectual Property Office (SIPO), and all four challenges were accepted by the PRB, with hearings conducted in September 2010 and rulings expected in the coming months. The Company believes the Fairchild and SG claims are without merit and intends to contest them vigorously.

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

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 that it accepts the claim withdrawal. The terms of this settlement agreement have no impact on the Company's financial statements.

The Company is unable to predict the outcome of legal proceedings with certainty, and there can be no assurance that Power Integrations will prevail in the above-mentioned unsettled litigations. These litigations, whether or not determined in Power Integrations' favor or settled, will be costly and will divert the efforts and attention of the Company's management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. 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.

**13. RECENT ACCOUNTING PRONOUNCEMENTS:**

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

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

In December 2010, FASB issued ASU No. 2010-28, *Intangibles - Goodwill and Other* (ASC Topic 350). Under Topic 350 on goodwill and other intangible assets, testing for goodwill impairment is a two-step test. When a



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goodwill impairment test is performed (either on an annual or interim basis), an entity must assess whether the carrying amount of a reporting unit exceeds its fair value (Step 1). If it does, an entity must perform an additional test to determine whether goodwill has been impaired and to calculate the amount of that impairment (Step 2). The amendments in this update modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors require that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on the Company's condensed consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Instruments. ASU No. 2010-06 amends ASC 820 to require additional disclosures regarding fair value measurements. Specifically, the ASU requires entities to disclose the amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy, to disclose reasons for any transfers in or out of Level 3 and to separately disclose information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements. In addition, the ASU also amends ASC 820 to clarify certain existing disclosure requirements. Except for the requirement to disclose information about purchases, sales, issuances and settlements in the reconciliation of recurring Level 3 measurements separately, the amendments to ASC 820 made by ASU No. 2010-06 were effective for the Company's 2010 interim and annual reporting periods. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements is effective for the Company's 2011 interim and annual reporting periods. The adoption of these provisions did not have a material impact on the Company's condensed consolidated financial statements.

**14. ACQUISITIONS:**

On February 26, 2010, the Company entered into a definitive agreement to purchase, for cash totaling \$11.5 million, the assets of an early-stage research and development company involved in developing certain technology that is consistent with the Company's long-term business strategy. The Company accounted for the transaction as an acquisition of a business and completed the acquisition on August 26, 2010. The Company allocated \$6.2 million of the purchase price to goodwill, which is deductible for tax purposes, \$4.7 million to in-process research and development, which the Company will amortize over the estimated life of the technology upon completion of its development, and \$0.6 million to fixed assets. The Company also expensed \$0.4 million of acquisition-related costs which were recorded as general and administrative expense in 2010. Goodwill recognized in the acquisition was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce.

On December 31, 2010, the Company acquired certain assets of Qspeed Semiconductor for approximately \$7.0 million in cash. In the quarter ended March 31, 2011, \$6.9 million was paid in connection with the acquisition. The Company accounted for the transaction as an acquisition of a business.

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

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

Cash	\$ 6,955
Settlement of preexisting arrangement	5,250
<b>Total</b>	<b>\$ 12,205</b>

Of the total consideration transferred, \$6.8 million was allocated to goodwill, which is deductible for tax purposes, \$1.8 million was allocated to developed technology, \$0.9 million was allocated to customer relationships, \$0.4 million was allocated to fixed assets, \$2.1 million was allocated to inventory, including \$0.6 million of inventory markup, which will be amortized to cost of revenues throughout 2011, and \$0.2 million was allocated to accounts receivable. Goodwill recognized in the acquisition of Qspeed Semiconductor was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce. The allocation of the purchase price is preliminary and may be adjusted should further information regarding events or circumstances existing at the acquisition date become available.

**15. INVESTMENT IN THIRD PARTY:**

On October 22, 2010, the Company made a \$7.0 million equity investment in a privately held company, SemiSouth Laboratories ( SemiSouth ). The Company accounts for its non-marketable investment in SemiSouth under the cost method as the Company has less than a 20% ownership interest in SemiSouth and does not have the ability to exercise significant influence over the investee. Also in October 2010, the Company paid \$10.0 million as a prepaid royalty in exchange for the right to use SemiSouth s technology. The Company will amortize the royalty to cost of revenues based on the Company s sales of products incorporating the licensed technology.

In connection with entering into these agreements, the Company entered into an agreement pursuant to which, among other things, it may be obligated to acquire SemiSouth if SemiSouth meets certain financial performance conditions.

The Company accounts for its non-marketable investment in SemiSouth Laboratories under the cost method. The investment is periodically reviewed for other-than-temporary declines in fair value by considering available evidence, including general market conditions, the company s financial condition, pricing in recent rounds of financing, earnings and cash flow forecasts, recent operational performance and any other readily available market data. The carrying value of the Company s investment in SemiSouth is \$7.0 million and was classified within other assets on the Company s consolidated balance sheet as of March 31, 2011.

**16. SUPPLIER AGREEMENT:**

The Company entered into a wafer supply agreement amendment with one of its foundries in the third quarter of 2008, which amends its previous agreement with the foundry. The amended agreement includes a Company prepayment of \$3.1 million for raw materials. 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, 2011, \$0.3 million remained as prepaid, and as of December 31, 2010, \$0.9 million remained prepaid under this agreement. The Company included the prepayment in prepaid expenses and other current assets in its March 31, 2011, and December 31, 2010, condensed consolidated balance sheets.

**17. LEASE LINE TO THIRD PARTY**

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In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the term of the agreement, SemiSouth can borrow up to \$15.5 million through January 2013. As of March 31, 2011, a total of \$5.7 million had been funded, comprising; \$3.8 million funded, less payments withheld under this lease arrangement to finance capital equipment commencing in February 2011, and \$1.9 million paid as deposits on equipment which the Company will lease to SemiSouth upon delivery of such equipment. The Company included the lease line receivable in Other Assets and Prepaid Expenses and Other Current Assets in its



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condensed consolidated balance sheet at March 31, 2011. The total lease payments related to the \$3.8 million funded will be received over a four to eight year term and is reflected in the table below (in millions):

<b>Fiscal Year</b>	<b>Total Minimum Lease Payments</b>
2011 (remaining 9 months)	\$ 0.4
2012	0.6
2013	0.6
2014	0.6
2015	0.5
Thereafter	1.5
<b>Total</b>	<b>\$ 4.2</b>

**18. BANK LINE OF CREDIT**

In February 2011, the Company entered into an unsecured credit agreement with a bank (the Credit Agreement). Pursuant to the Credit Agreement, the Company can request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. The agreement also covers advances for commercial letters of credit. At March 31, 2011, the Company had a \$0.5 million outstanding letter of credit for a capital purchase deposit. The terms of this credit agreement require the Company to remain in compliance with certain financial and other covenants.

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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, 2010 filed with the SEC on February 25, 2011. 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 and mixed-signal integrated circuits ( ICs ) for use in electronic power supplies, also known as switched-mode power supplies. Following our acquisition of Qspeed Semiconductor in December 2010, we also now offer a range of high-performance, high-voltage silicon diodes. Our ICs and diodes are used principally in AC-DC power supplies in a wide variety of end products, primarily in the consumer, communications, computer and industrial electronics markets. For example, our ICs are commonly used in such end products as mobile-phone chargers, desktop computers, home entertainment equipment, appliances, utility meters and LED light bulbs and fixtures.

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

While the size of the power-supply market fluctuates with changes in macroeconomic conditions, the market has generally exhibited a modest growth rate over time as growth in the unit volumes of power supplies has largely been offset by reductions in the average selling price of components in this market. Therefore, the growth 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 in recent years, and we continue to expand our offerings of technical documentation and design-support tools and services in order to help customers use our ICs. These tools and services include our *PI Expert* design software, which we offer free of charge, and our transformer-sample service.

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

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

*Increase the penetration of our products in high-power applications.* We believe we have developed 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, among others.



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Our quarterly 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. We plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. Strong demand for our products in recent periods resulted in shortages of certain products and caused an extension of our lead times for delivery to customers. We have added production capacity in order to ensure that we can satisfy customer demand, and our lead times have now returned to historical levels on most of our products; however, if we do not have adequate inventory of products to satisfy future demand, our operating results may be impacted.

Our net revenues were \$76.8 million and \$71.5 million in the first quarters of 2011 and 2010, respectively. The growth of revenues year over year reflects increased penetration of our products into our addressable markets, as well as overall growth in demand for electronic products. Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for 67% and 60% of our net revenues in the first quarters of 2011 and 2010, respectively. Our top two customers, both distributors of our products, collectively accounted for approximately 31% and 24% of our net revenues in the first quarters of 2011 and 2010, respectively, and international sales comprised 96% and 95% of our net revenues in the in this first quarters of 2011 and 2010, respectively.

Because our industry is intensely price-sensitive, our gross margin (gross profit divided by net revenues) is subject to change based on the relative pricing of solutions that compete with ours. Variations in product and customer mix can also cause our gross margin to fluctuate. Also, because we purchase a large percentage of our silicon wafers from foundries located in Japan, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. 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. The current earthquake and tsunami in Japan did not have a material impact on our customers and suppliers in the first quarter of 2011; nor do we expect these events to have a material impact to our customers or suppliers in our second quarter.

Our gross profit, defined as net revenues less cost of revenues, was \$36.4 million, or 47% of net revenues, in the first quarter of 2011, compared to \$35.9 million, or 50% of net revenues, in the same period of 2010. The reduction in our gross margin in the first quarter of 2011 was driven primarily by the following factors: product mix and the weakening of the U.S. dollar compared with the Japanese yen, which increases the cost of our silicon wafers. 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 2011 and 2010 were \$24.7 million and \$21.0 million, respectively. The increase in operating expenses in 2011 compared with 2010 was driven primarily by; increased payroll and related expenses and higher stock-based compensation expenses, due to increased headcount, including research and development headcount increases resulting from an acquisition we completed in 2010; and increases in sales and marketing expenses as we expand our Asia sales staff. General and administrative expenses increased as a result of increased legal fees related to patent litigation.

### **Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ( U.S. GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those listed below. We base our estimates on historical facts and various other assumptions that we believe to be reasonable at the time the estimates are made. Actual results could differ from those estimates.

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Our critical accounting policies are as follows:

revenue recognition;

stock-based compensation;

estimating distributor pricing credits;

estimating write-downs for excess and obsolete inventory;

income taxes; and

goodwill and intangible assets.

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

**Revenue recognition**

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

We apply the provisions of ASC 605-10 (formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*) and all related appropriate guidance. We recognize revenue when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable and (4) collectability is reasonably assured. We generally use customer purchase orders to determine the existence of an arrangement. We consider delivery to have occurred when title and risk of loss have transferred to the customer. We consider the price to be fixed based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based on the creditworthiness of the customer as determined by credit checks we perform as well as the customer's payment history.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method. Sales to distributors are made under terms allowing certain price protection and rights of return on our products held by the distributors. As a result of these rights, we defer the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell our products to their end customers. We determine the amount to defer based on the level of actual inventory on hand at our distributors as well as inventory in transit to our distributors. Fluctuations in deferred income on sales to distributors coincide with an increase or decrease in revenue shipments to our distributors; in addition, deferred income levels are also impacted by the speed at which our distributors sell our products to their end customers. The gross profit that is deferred as a result of this policy is reflected as deferred income on sales to distributors in the accompanying consolidated balance sheets. The total deferred revenue as of March 31, 2011 and December 31, 2010 was approximately \$23.1 million and \$24.7 million, respectively. The total deferred cost as of March 31, 2011 and December 31, 2010 was approximately \$12.2 million and \$12.5 million, respectively.

**Stock-based compensation**

We apply the provisions of ASC 718-10, *Share-Based Payment*. Under the provisions of ASC 718-10, we recognize the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. We use estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation cost to recognize. Changes in these estimates could result in changes to our compensation charges.

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### **Estimating distributor pricing credits**

Historically, between one-half and two-thirds of our total sales have been made through distributors. Frequently, distributors need a cost lower than our standard sales price in order to win business. After the distributor ships product to its customer, the distributor submits a ship and debit claim to us in order to adjust its cost from the standard price to the approved lower price. After verification by us, a credit memo is issued to the distributor to adjust the sell-in price from the standard distribution price to the pre-approved lower price. We maintain a reserve for these credits that appears as a reduction to accounts receivable in our consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in our current and/or future net revenues. To establish the adequacy of our reserves, we analyze historical ship and debit amounts and levels of inventory in the distributor channels. If our reserves are not adequate, our net revenues could be adversely affected.

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

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

### **Income taxes**

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

We account for income taxes under the provisions of ASC 740 (formerly SFAS No. 109, *Accounting for Income Taxes*). Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize valuation allowances to reduce any deferred tax assets to the amount that we estimate will more likely than not be realized based on available evidence and management's judgment. We limit the deferred tax assets recognized related to certain of our officers' compensation to amounts that we estimate will be deductible in future periods based upon Internal Revenue Code Section 162(m). In the event that we determine, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, we would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial position.

As of March 31, 2011, we continued to maintain a valuation allowance on a portion of our California deferred tax assets as we believe that it is not more likely than not that the deferred tax assets will be fully realized. We also maintain a valuation allowance with respect to certain of our deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

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

**Table of Contents****Goodwill and intangible assets**

In accordance with ASC 350-10, *Goodwill and Other Intangible Assets*, we evaluate goodwill for impairment on an annual basis, or as other indicators of impairment emerge. The provisions of ASC 350-10 require that we perform a two-step impairment test. In the first step, we compare the implied fair value of our single reporting unit to its carrying value, including goodwill. If the fair value of our reporting unit exceeds the carrying amount no impairment adjustment is required. If the carrying amount of our reporting unit exceeds the fair value, step two will be completed to measure the amount of goodwill impairment loss, if any exists. If the carrying value of our single reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference, but not in excess of the carrying amount of the goodwill. We evaluated goodwill for impairment in the fourth quarter 2010, and concluded that no impairment existed as of December 31, 2010. Additionally, no impairment indicators have been identified during the three months ended March 31, 2011.

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

**Results of Operations**

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenues	100.0%	100.0%
Cost of revenues	52.6	49.8
Gross profit.	47.4	50.2
Operating expenses:		
Research and development	13.1	11.3
Sales and marketing	10.7	9.7
General and administrative	8.4	8.4
Total operating expenses	32.2	29.4
Income from operations	15.2	20.8
Other income, net	0.6	0.7
Income before provision for income taxes	15.8	21.5
Provision for income taxes	3.0	4.3
Net income	12.8%	17.2%

*Comparison of the Three Months Ended March 31, 2011 and 2010*

*Net revenues.* Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three months ended March 31, 2011 were \$76.8 million compared to \$71.5 million for the three months ended March 31, 2010, an increase of \$5.3 million, or 7%. 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 a broad range of applications within three of our major end markets (communications, consumer and industrial); sales into the computer end market decreased slightly compared with the first quarter of 2010.





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Our net revenue mix by product family for the three months ended March 31, 2011 compared with the three months ended March 31, 2010 was as follows:

Product Family	Three Months Ended	
	March 31,	
	2011	2010
LinkSwitch	40%	36%
TinySwitch	35%	39%
TOPSwitch	23%	24%
Other	2%	1%

Approximate revenue mix by end markets served for the three months ended March 31, 2011 compared with the three months ended March 31, 2010, was as follows:

End Market	Three Months Ended	
	March 31,	
	2011	2010
Consumer	37%	36%
Communication	32%	32%
Computer	11%	12%
Industrial	20%	20%

International sales, defined as sales outside of the Americas based on ship to customer locations, were \$73.5 million in the first quarter of 2011 compared with \$67.6 million for the same period in 2010, an increase of approximately \$5.9 million. International sales represented 96% and 95% of net revenues in the three months ended March 31, 2011 and 2010, respectively. 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% of our net revenues for both the three months ended March 31, 2011 and 2010.

Sales through distributors accounted for 68% of net sales for the first quarter of 2011 and 32% of net sales were to OEMs and power supply manufactures; the corresponding figures for the first quarter of 2010 were 66% and 34%, respectively. Two customers, both distributors of our products, accounted for 19% and 12% of net revenues in the three months ended March 31, 2011. The same two distributors accounted for 13% and 11% of net revenues in the three months ended March 31, 2010. No other customers 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 and gross margin for the three months ended March 31, 2011 and 2010 (dollars in millions):

	Three Months Ended	
	March 31,	
	2011	2010
Net revenues	\$ 76.8	\$ 71.5
Gross profit	\$ 36.4	\$ 35.9
Gross margin	47.4%	50.2%

The decrease in our gross margin in the first quarter of 2011 compared to the same period in 2010 was driven primarily by product mix; also contributing to the decrease in our gross margin was the weakening of the U.S. dollar compared with the Japanese yen, which increases the cost of our silicon wafers.



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*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, 2011 and 2010 (dollars in millions):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenues	\$ 76.8	\$ 71.5
R&D expenses	\$ 10.0	\$ 8.1
R&D expenses as a % of net revenue	13.1%	11.3%

R&D expenses increased in the first quarter of 2011 compared to the first quarter of 2010, driven primarily by increased payroll and related expenses, including stock-based compensation expenses, resulting from increased headcount, which in turn was due primarily to our acquisition completed in the third quarter of 2010 (See Note 14 of Notes to Condensed Consolidated Financial Statements, Acquisitions, for details), and increased engineering materials expense related to new product development.

*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, 2011 and 2010 (dollars in millions):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenues	\$ 76.8	\$ 71.5
Sales and marketing expenses	\$ 8.2	\$ 6.9
Sales and marketing expenses as a % of net revenue	10.7%	9.7%

The increase in sales and marketing expenses in the first quarter of 2011 compared to the first quarter of 2010 was driven primarily by increased payroll and related expenses, including stock-based compensation expenses as a result of increased headcount to expand our international sales staff.

*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, 2011 and 2010 (dollars in millions):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenues	\$ 76.8	\$ 71.5
G&A expenses	\$ 6.5	\$ 6.0
G&A expenses as a % of net revenue	8.4%	8.4%

G&A expenses remained flat as a percentage of revenue, and increased in absolute dollars primarily as a result of increased legal expenses related to patent litigation.

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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, 2011 and 2010 (dollars in millions):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenues	\$ 76.8	\$ 71.5
Other income, net	\$ 0.4	\$ 0.5
Other income, net as a % of net revenue	0.6%	0.7%

The reduction in other income, net, for the first quarter of 2011 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, 2011 and 2010 (dollars in millions):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Income before provision for income taxes	\$ 12.1	\$ 15.4
Provision for income taxes	\$ 2.3	\$ 3.1
Effective tax rate	18.7%	19.9%

The difference between the expected statutory rate of 35% and our effective tax rate for the first quarter of 2011 was primarily due to the beneficial impact of the geographic distribution of our world-wide earnings and the beneficial impact of a research and experimentation tax credit. The difference between the expected statutory rate of 35% and our effective tax rate for the first quarter of 2010 was primarily due to the beneficial impact of the geographic distribution of our world-wide earnings partially offset by a valuation allowance on our California deferred tax asset.

*Outlook for our Second Quarter of 2011*

In conjunction with the release of our quarter ended March 31, 2011, results on May 2, 2011, we issued the following outlook for the second quarter of 2011:

Quarterly revenues are expected to be between \$76 million and \$82 million;

Gross margin is expected to be between 47 and 48 percent; and

Operating expenses are expected to be approximately \$25.5 million.

**Liquidity and Capital Resources**

As of March 31, 2011, we had \$206.6 million in cash, cash equivalents and short-term and long-term investments a decrease of approximately \$8.2 million from \$214.8 million as of December 31, 2010. As of March 31, 2011, we had working capital, defined as current assets less current liabilities, of \$222.5 million, an increase of approximately \$10.4 million from \$212.1 million as of December 31, 2010.

In February 2011, we entered into an unsecured credit agreement with a bank (the Credit Agreement). Pursuant to the Credit Agreement, we can request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. The agreement also covers advances for commercial letters of credit. We currently have an outstanding letter of credit for a capital purchase deposit; as of March 31, 2011, this letter of

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credit totaled approximately \$0.5 million. The terms of the credit agreement require us to remain in compliance with certain modified quick ratio and tangible net worth financial and other covenants, which we are in compliance with.

Our operating activities generated cash of \$5.7 million in the three months ended March 31, 2011, driven primarily by i) net income of \$9.9 million, which included the impact of non-cash depreciation, amortization and stock-based compensation expenses totaling \$3.7 million, \$0.2 million and \$2.5 million, respectively, ii) an increase in prepaid expenses and other assets of \$1.4 million, due primarily to the amortization of prepaid legal expenses in the first quarter of 2011. These sources of cash were partially offset by; i) an increase in accounts receivable of \$7.6 million, related to

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increased customer shipments in the first quarter of 2011 compared to the fourth quarter of 2010, ii) a decrease in accounts payable of \$2.9 million related to the timing of invoice payment processing, and iii) a decrease in deferred income on sales to distributors of \$1.3 million, due primarily to a decrease in our distributor inventory levels compared to the prior quarter, reducing the related deferred revenue.

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, amortization and stock-based compensation expenses totaling \$2.8 million, \$0.2 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 investing activities in the three months ended March 31, 2011 resulted in a \$29.9 million use of cash, consisting of; (i) \$10.2 million of net purchases of held-to-maturity investments, (ii) \$7.2 million for purchases of property and equipment, (iii) \$6.9 million paid in relation to the acquisition of QSpeed (see Note 14 of Notes to Condensed Consolidated Financial Statements related to our acquisitions), and (iv) \$5.5 million net, in connection with our lease line of credit to SemiSouth Laboratories (see Note 17 of Notes to Condensed Consolidated Financial Statements related to our lease line to SemiSouth). 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 eventually acquired (see Note 14 of Notes to Condensed Consolidated Financial Statements related to our acquisition of an early-stage research and development company).

In the three months ended March 31, 2011, we received \$6.2 million, net, from financing activities. We received \$7.3 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan. These receipts were partially offset by \$1.4 million for the payment of dividends to stockholders.

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 paid dividends on a quarterly basis in 2010, which resulted in approximately a \$1.4 million use of cash each quarter. In October 2010, our board of directors declared an additional four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2011. The first quarterly dividend payment of approximately \$1.4 million was made on March 31, 2011, to stockholders of record as of February 28, 2011. We expect that each of the remaining quarterly dividends will result in a similar use of cash. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of our stockholders.

In May, 2009, we announced that our board of directors had authorized the use of up to \$25 million for the repurchase of shares of our common stock. From May 14, 2009 to December 31, 2009, we purchased 0.5 million shares of our common stock for approximately \$11.0 million, and in the first two quarters of 2010 we purchased 0.4 million shares of our common stock for approximately \$14.0 million (including fees), concluding this repurchase program.

In February 2011, our board of directors authorized the use of an additional \$50 million for the repurchase of our common stock. Repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors; the guidelines do not provide for repurchases at current stock price levels. There is no expiration date for this stock repurchase program.

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As of March 31, 2011 we have a contractual obligation related to income tax, which is comprised primarily of unrecognized tax benefits of approximately \$30.7 million. The tax obligation was classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next year.

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

In February 2011, we entered into an agreement to provide a lease line for the financing of capital equipment, in connection with our investment in SemiSouth Laboratories. Under the term of the agreement, SemiSouth Laboratories can borrow up to \$15.5 million through January 2013. As of March 31, 2011, \$5.7 million had been funded under this arrangement, less payments withheld (see Note 17 of Notes to Condensed Consolidated Financial Statements for further details on our lease line to SemiSouth).

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, 2010.

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

## **Recent Accounting Pronouncements**

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

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

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



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below its carrying amount. The amendments in this update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU in the first quarter of 2011 did not have a material impact on our condensed consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Instruments. ASU No. 2010-06 amends ASC 820 to require additional disclosures regarding fair value measurements. Specifically, the ASU requires entities to disclose the amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy, to disclose reasons for any transfers in or out of Level 3 and to separately disclose information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements. In addition, the ASU also amends ASC 820 to clarify certain existing disclosure requirements. Except for the requirement to disclose information about purchases, sales, issuances and settlements in the reconciliation of recurring Level 3 measurements separately, the amendments to ASC 820 made by ASU No. 2010-06 were effective for the Company's 2010 interim and annual reporting periods. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements were effective for the Company's 2011 interim and annual reporting periods. The adoption of these provisions did not have a material impact on our condensed consolidated financial statements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

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

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

*Foreign Currency Exchange Risk.* 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. dollar. Each year, our management and Epson review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between both parties. 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.

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### ITEM 4. CONTROLS AND PROCEDURES.

#### *Limitation on Effectiveness of Controls*

Any control system, no matter how well designed and operated, can provide only reasonable assurance as to the tested objectives. The design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. The inherent limitations in any control system include the realities that judgments related to decision-making can be faulty, and that reduced effectiveness in controls can occur because of simple errors or mistakes. Due to the inherent limitations in a cost-effective control system, misstatements due to error may occur and may not be detected.

#### *Evaluation of Disclosure Controls and Procedures*

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our 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 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, 2011, which materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

### ITEM 1A. RISK FACTORS

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

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

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

the volume and timing of orders received from customers;

competitive pressures on selling prices;

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the demand for our products declining in the major end markets we serve, which may occur due to competitive factors, supply-chain fluctuations or changes in macroeconomic conditions;

the volume and timing of delivery of orders placed by us with our wafer foundries and assembly subcontractors;

the inability to adequately protect or enforce our intellectual property rights;

fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen;

an audit by the Internal Revenue Service, which is asserting that we owe additional taxes relating to a number of tax related positions;

continued impact of recently enacted changes in securities laws and regulations, including potential risks resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002;

expenses we are required to incur (or choose to incur) in connection with our intellectual property litigations;

the lengthy timing of our sales cycle;

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

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;

our ability to attract and retain qualified personnel;

risks associated with acquisitions and strategic investments;

our ability to successfully integrate, or realize the expected benefits from, our acquisitions;

changes in environmental laws and regulations, including with respect to energy consumption and climate change; and

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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 67% and 62% of our net revenues for the quarter ended March 31, 2011 and the year ended December 31, 2010, respectively. The ordering patterns of some of our existing large customers have been unpredictable in the past and we expect that customer-ordering patterns will continue to be unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without significant penalty to the customer. In the past, we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time.

*Intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products.* The high-voltage power supply industry is intensely competitive and

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

*If demand for our products declines in our major end markets, our net revenues will decrease.* A limited number of applications of our products, such as cellphone chargers, standby power supplies for PCs, and power supplies for home appliances comprise a significant percentage of our net revenues. We expect that a significant level of our net revenues and operating results will continue to be dependent upon these applications in the near term. The demand for these products has been highly cyclical and has been impacted by economic downturns in the past. Any economic slowdown in the end markets that we serve could cause a slowdown in demand for our ICs. When our customers are not successful in maintaining high levels of demand for their products, their demand for our ICs decreases, which adversely affects our operating results. Any significant downturn in demand in these markets would cause our net revenues to decline and could cause the price of our stock to fall.

*We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient quantities of wafers, our business may suffer.* We have supply arrangements for the production of wafers with OKI, XFAB and Epson. Our contracts with these suppliers expire in April 2018, December 2012 and December 2020, 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 and adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

In addition, if prices for commodities used in our products increase significantly, raw material costs would increase for our suppliers which could result in an increase in the prices our suppliers charge us. (Recent increases in the price of gold, 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.

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*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.

*\* We are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of tax related positions, and if we are not successful in defending our positions we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future.* Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by the IRS and state, local and foreign tax authorities. In connection with an IRS audit of our United States federal income tax returns for fiscal years 2002 and 2003, the IRS proposed a material adjustment related to our research and development cost-sharing arrangement. We are disputing the proposed adjustment, but at the request of the IRS, we agreed to rollover the disputed proposed adjustment into the audit of our United States Federal income tax returns for fiscal years 2004 through 2006. In the quarter ended March 31, 2011, we received Notices of Proposed Adjustments from the IRS showing proposed changes to our taxable income for fiscal years 2003 through 2006, primarily related to our intercompany research and development cost-sharing arrangement. The fiscal years 2007 through 2009 are also under audit by the IRS. While the IRS has not completed its audit for these years, we anticipate that it will again propose an adjustment related to our intercompany research and development cost-sharing arrangement.

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

*Securities laws and regulations, including potential risk resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002, will continue to impact our results.* Complying with the requirements of the Sarbanes-Oxley Act of 2002 and NASDAQ's conditions for continued listing have imposed significant legal and financial compliance costs, and are expected to continue to impose significant costs and management burden on us. These rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of

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our board of directors, particularly qualified members to serve on our audit committee. Further, the rules and regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which are to become effective throughout 2011, are also expected to continue to impose significant costs and management burden on us.

Additionally, because these laws, regulations and standards promulgated by the Sarbanes-Oxley Act are, and those promulgated under the Dodd-Frank Act when they become effective are expected to be, subject to varying interpretations, their application in practice may evolve over time as new guidance becomes available. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

*If we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use certain technologies.* We are currently involved in a number of patent litigation matters and the outcome of the litigation is uncertain. See Note 12, Legal Proceedings, in Notes to Condensed Consolidated Financial Statements in Item 1 of Part I. For example, in one of our patent suits the infringing company has been found to infringe four of our patents. Despite the favorable court finding, the infringing party filed an appeal to the damages awarded. In another matter, we are being sued for patent infringement in China, where the outcome of litigation can be more uncertain than in the United States. Should we ultimately be determined to be infringing on another party's patents, or if an injunction is issued against us while litigation is pending on those claims, such result could have an adverse impact on our ability to sell products found to be infringing, either directly or indirectly. In the event of an adverse outcome, we may be required to pay substantial damages, stop our manufacture, use, sale, or importation of infringing products, or obtain licenses to the intellectual property we are found to have infringed. We have also incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits, including the appeal of the case we won, and our involvement in this litigation and any future intellectual property litigation could adversely affect sales and divert the efforts and attention of our technical and management personnel, whether or not such litigation is resolved in our favor. Thus, even if we are successful in these lawsuits, the benefits of this success may fail to outweigh the significant legal costs we will have incurred.

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

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

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

potential insolvency of international distributors and representatives;



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reduced protection for intellectual property rights in some countries;

the impact of recessionary environments in economies outside the United States;

tariffs and other trade barriers and restrictions;

the burdens of complying with a variety of foreign and applicable U.S. Federal and state laws; and

foreign-currency exchange risk.

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

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

In addition, we cannot be sure that we will be able to adjust to changing market demands as quickly and cost-effectively as necessary to compete successfully. Furthermore, we cannot assure that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Our failure, or our customers' failure, to develop and introduce new products successfully and in a timely manner would harm our business. In addition, customers may defer or return orders for existing products in response to the introduction of new products. When a potential liability exists we will maintain reserves for customer returns, however we cannot assure that these reserves will be adequate.

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

*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.

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

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

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

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

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

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

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

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

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

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

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

In February 2011, our board of directors authorized the use of an additional \$50 million for the repurchase of our common stock. Repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors; the guidelines do not provide for repurchases at current stock price levels. This program commenced in February 2011, and has no expiration date.



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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 5, 2011

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

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<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	Amendment No. 2 to Wafer Supply Agreement, as amended, between Seiko Epson Corporation and Power Integrations International, Ltd., entered into on January 5, 2011 (As filed with the SEC as Exhibit 10.47 to our Annual Report on Form 10-K on February 25, 2011, SEC File No. 000-23441).
10.2	2011 Executive Compensation Arrangements (Described under Item 5.02 of our Current Report on Form 8-K, as filed with the SEC on January 31, 2011, 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.**
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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

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