

POWER INTEGRATIONS INC  
Form 10-Q  
August 01, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**FORM 10-Q**

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006.

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-23441

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**POWER INTEGRATIONS, INC.**

(Exact name of registrant as specified in its charter)

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**DELAWARE**  
(State or other jurisdiction of

Incorporation or organization)

5245 Hellyer Avenue, San Jose, California 95138

(Address of principal executive offices) (Zip code)

**94-3065014**  
(I.R.S. Employer

Identification No.)

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(408) 414-9200

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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

| Class                          | Outstanding at June 30, 2007 |
|--------------------------------|------------------------------|
| Common Stock, \$.001 par value | 28,682,476 shares            |

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**EXPLANATORY NOTE REGARDING RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

This Report on Form 10-Q contains the restatement of our condensed consolidated statements of income for the three and nine months ended September 30, 2005 and condensed consolidated statements of cash flows for the nine months ended September 30, 2005.

Based upon an investigation and determinations made by a Special Committee of our board of directors and management's undertaking of a separate review of historical stock option activity subsequent to the issuance of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, we identified errors in our accounting related to stock option compensation expenses in prior periods. We determined that corrections to previously issued consolidated financial statements were required to reflect additional material charges for stock-based compensation expenses and related income and payroll tax effects.

Our restated consolidated retained earnings as of September 30, 2005 incorporates an aggregate of approximately \$30.5 million in incremental stock-related compensation expense relating to fiscal years 1998 through the quarter ended September 30, 2005. This expense is net of a \$13.5 million tax benefit related to the restatement adjustments. This additional expense results from our determination that the dates initially used to measure compensation expense for various stock option grants (options to purchase an aggregate of 7,988,189 shares) to employees, executive officers and non-employee directors during the period could not be relied upon. We determined that the revised measurement dates differed from the originally recorded measurement dates due primarily to (1) insufficient or incomplete corporate approvals, (2) grants that were determined to have been cancelled and repriced and (3) grants in which vesting was accelerated. These included annual grants to existing employees and officers, option grants to non-employee directors, and option grants made to new hires. Our board of directors has ratified each of the options granted, and we intend to honor each stock option granted pursuant to the terms of the applicable stock option plan and stock option agreement.

In those cases in which we previously used a measurement date that we determined could no longer be relied upon, we have developed and applied a methodology to remeasure those stock option grants and record the relevant expense. For more information on our restatement, including the methodology we adopted, see Item 2, Management's Discussion of Financial Condition and Results of Operations - Restatement of Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2005 and note 3 of notes to our condensed consolidated financial statements appearing in Item 1 of this Report on Form 10-Q.

In addition to the restatements for stock-based compensation expenses, we recorded adjustments to correct other errors that occurred in the periods ended December 31, 2001 through the third quarter of 2005 which have been reflected in the restated consolidated financial statements. The restatements, including the nature thereof, are further discussed in note 3 of notes to our accompanying condensed consolidated financial statements appearing in Item 1 of this Report on Form 10-Q.

All financial information contained in this Report on Form 10-Q gives effect to the restatements of our consolidated financial statements as described above. We have not amended, and we do not intend to amend, our previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for each of the fiscal years and fiscal quarters of 1998 through 2004, and for the first nine months of the fiscal year ended December 31, 2005. Financial information included in reports previously filed or furnished by Power Integrations, Inc. for the periods from January 1, 1998 through September 30, 2005 should not be relied upon and are superseded by the information in our 2005 Annual Report on Form 10-K, filed on March 8, 2007.

Management has determined that we have a material weakness in our internal control over financial reporting relating to the implementation and administration of our stock option program, and the accounting for grants thereunder. As described in more detail in Part I, Item 4, of this Report on Form 10-Q, based upon direction of a Special Committee of the board of directors, we have identified and are implementing several measures designed to remedy this material weakness.

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**Cautionary Note Regarding Forward Looking Statements**

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

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## PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
**POWER INTEGRATIONS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)****(In thousands)**

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| <b>CURRENT ASSETS:</b>  |                       |                      |
| Cash and cash equivalents   | \$ 101,505            | \$ 109,879           |
| Short-term investments  | 21,443                | 16,200               |
| Accounts receivable, net of allowances of \$527 and \$469, respectively | 13,668                | 13,488               |
| Inventories   | 26,859                | 17,929               |
| Deferred tax assets   | 1,551                 | 1,551                |
| Prepaid expenses and other current assets                               | 4,094                 | 1,328                |
| <b>Total current assets</b>   | <b>169,120</b>        | <b>160,375</b>       |
| <b>INVESTMENTS</b>  | <b>5,409</b>          | <b>4,422</b>         |
| <b>NOTE RECEIVABLE</b>  | <b>10,000</b>         | <b>10,000</b>        |
| <b>PROPERTY AND EQUIPMENT, net</b>                                      | <b>53,727</b>         | <b>48,890</b>        |
| <b>INTANGIBLE ASSETS, net</b>   | <b>6,089</b>          | <b>3,594</b>         |
| <b>DEFERRED TAX ASSETS</b>  | <b>10,817</b>         | <b>9,221</b>         |
| <b>OTHER ASSETS</b>   | <b>509</b>            | <b>419</b>           |
| <b>Total assets</b>   | <b>\$ 255,671</b>     | <b>\$ 236,921</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                              |                       |                      |
| <b>CURRENT LIABILITIES:</b>   |                       |                      |
| Accounts payable  | \$ 11,868             | \$ 5,410             |
| Accrued payroll and related expenses                                    | 6,934                 | 7,038                |
| Income taxes payable  | 11,503                | 10,277               |
| Deferred income on sales to distributors                                | 5,385                 | 3,479                |
| Accrued professional fees   | 5,458                 | 1,270                |
| Other accrued liabilities   | 503                   | 88                   |
| <b>Total current liabilities</b>  | <b>41,651</b>         | <b>27,562</b>        |
| <b>STOCKHOLDERS EQUITY:</b>   |                       |                      |
| Common stock  | 29                    | 29                   |
| Additional paid-in capital  | 131,652               | 134,196              |
| Deferred compensation   |                       | (746)                |
| Accumulated translation adjustment                                      | (50)                  | (121)                |

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|  |            |            |
|--|------------|------------|
| Retained earnings                          | 82,389     | 76,001     |
| Total stockholders' equity                 | 214,020    | 209,359    |
| Total liabilities and stockholders' equity | \$ 255,671 | \$ 236,921 |

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

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

|  | Three Months Ended |                         | Nine Months Ended |                         |
|--|--------------------|-------------------------|-------------------|-------------------------|
|  | September 30,      |                         | September 30,     |                         |
|  | 2006               | 2005<br>As restated (1) | 2006              | 2005<br>As restated (1) |
| NET REVENUES                             | \$ 44,404          | \$ 36,543               | \$ 121,122        | \$ 105,196              |
| COST OF REVENUES COST OF REVENUES        | 20,355             | 18,487                  | 54,622            | 53,995                  |
| GROSS PROFIT                             | 24,049             | 18,056                  | 66,500            | 51,201                  |
| OPERATING EXPENSES:                      |                    |                         |                   |                         |
| Research and development                 | 6,331              | 4,273                   | 18,158            | 12,753                  |
| Sales and marketing                      | 6,330              | 4,573                   | 19,054            | 13,189                  |
| General and administrative               | 10,210             | 4,248                   | 26,732            | 10,531                  |
| Total operating expenses                 | 22,871             | 13,094                  | 63,944            | 36,473                  |
| INCOME FROM OPERATIONS                   | 1,178              | 4,962                   | 2,556             | 14,728                  |
| OTHER INCOME, NET                        | 1,585              | 924                     | 4,357             | 2,358                   |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 2,763              | 5,886                   | 6,913             | 17,086                  |
| PROVISION FOR INCOME TAXES               | 102                | 616                     | 525               | 2,734                   |
| NET INCOME                               | \$ 2,661           | \$ 5,270                | \$ 6,388          | \$ 14,352               |
| EARNINGS PER SHARE:                      |                    |                         |                   |                         |
| Basic                                    | \$ 0.09            | \$ 0.18                 | \$ 0.22           | \$ 0.48                 |
| Diluted                                  | \$ 0.09            | \$ 0.17                 | \$ 0.21           | \$ 0.46                 |
| SHARES USED IN PER SHARE CALCULATION:    |                    |                         |                   |                         |
| Basic                                    | 28,650             | 29,478                  | 29,192            | 29,605                  |
| Diluted                                  | 29,832             | 30,849                  | 30,887            | 30,890                  |

(1) See note 3, Restatement of Condensed Consolidated Financial Statements of the accompanying notes to the condensed consolidated financial statements.

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>Nine Months Ended September 30,</b> |                     |
|---|--|---------------------|
|   | <b>2006</b>                            | <b>2005</b>         |
|   |  | <b>As</b>           |
|   |  | <b>restated (1)</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |  |                     |
| Net income  | \$ 6,388                               | \$ 14,352           |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                     |
| Depreciation and amortization   | 5,164                                  | 4,739               |
| Stock-based compensation expense  | 11,823                                 | 2,281               |
| Deferred income taxes   | (1,596)                                | 134                 |
| Provision for accounts receivable and other allowances                            | 1,383                                  | 443                 |
| Excess tax benefit from stock options exercised                                   | (169)                                  |                     |
| Tax benefit associated with employee stock plans                                  | 153                                    | 695                 |
| Change in operating assets and liabilities:                                       |  |                     |
| Accounts receivable   | (1,563)                                | (2,442)             |
| Inventories   | (8,624)                                | 3,182               |
| Prepaid expenses and other current assets   | (2,856)                                | 1,298               |
| Accounts payable  | 4,903                                  | (1,936)             |
| Taxes payable and accrued liabilities   | 5,787                                  | (366)               |
| Deferred income on sales to distributors  | 1,906                                  | (56)                |
| <b>Net cash provided by operating activities</b>                                  | <b>22,699</b>                          | <b>22,324</b>       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |  |                     |
| Purchases of property and equipment   | (7,933)                                | (2,616)             |
| Acquisition of technology patents / licenses                                      | (3,000)                                | (1,094)             |
| Loan to supplier  |  | (10,000)            |
| Purchases of held-to-maturity investments   | (24,851)                               | (6,806)             |
| Proceeds from maturities of held-to-maturity investments                          | 18,622                                 | 11,271              |
| <b>Net cash used in investing activities</b>                                      | <b>(17,162)</b>                        | <b>(9,245)</b>      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |  |                     |
| Net proceeds from issuance of common stock  | 5,563                                  | 6,973               |
| Repurchase of common stock  | (19,643)                               | (28,305)            |
| Excess tax benefit from stock options exercised                                   | 169                                    |                     |
| <b>Net cash used in financing activities</b>                                      | <b>(13,911)</b>                        | <b>(21,332)</b>     |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>(8,374)</b>                         | <b>(8,253)</b>      |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>109,879</b>                         | <b>107,396</b>      |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 101,505</b>                      | <b>\$ 99,143</b>    |

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SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

|                                   |    |       |    |      |
|-----------------------------------|----|-------|----|------|
| Unpaid property and equipment     | \$ | 1,556 | \$ | (81) |
| Deferred stock-based compensation | \$ | (746) | \$ | 395  |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

|                                 |    |     |    |       |
|---------------------------------|----|-----|----|-------|
| Cash paid for income taxes, net | \$ | 724 | \$ | 2,298 |
|---------------------------------|----|-----|----|-------|

(1) See note 3, Restatement of Condensed Consolidated Financial Statements of the accompanying notes to the condensed consolidated financial statements.

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. 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, 2005, as presented in the Company's Annual Report on Form 10-K, filed on March 8, 2007 with the Securities and Exchange Commission.

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

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

The Company considers cash invested in highly liquid financial instruments with remaining maturities of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of September 30, 2006 and December 31, 2005, 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.

*Revenue Recognition*

Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. Shipping terms to the Company's international OEMs and merchant power supply manufacturers from its facility in California are delivered at frontier, commonly referred to as DAF. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of the product in that country. Shipping terms to the Company's international OEMs and merchant power supply manufacturers shipped 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 North American OEMs and merchant power supply manufacturers are FOB-point of origin meaning that revenue is recognized upon shipment, when the title is passed to the customer.

Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines 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 its distributors as well as inventory that is in transit to its 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.

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**POWER INTEGRATIONS, INC.**

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

*Common Stock*

On October 19, 2005, the Company announced that its board of directors had authorized a stock repurchase program of up to \$25.0 million of the Company's common stock. During the six months ended June 30, 2006 the Company purchased 1.1 million shares of its common stock for \$19.6 million. From inception of the stock repurchase program through June 30, 2006, the Company repurchased 1.3 million shares for a total of \$25.0 million, concluding this stock repurchase program. The Company did not repurchase stock in the three months ended September 30, 2006.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 on-going basis, the Company evaluates its estimates, including those related to revenue recognition and allowances for receivables and inventories. These estimates are based on historical facts and various other assumptions that the Company believes to be reasonable at the time the estimates are made.

*Comprehensive Income*

Comprehensive income for the Company consists of net income, plus the effect of foreign currency translation adjustments, which were not material for the nine months ended September 30, 2006 and 2005. Accordingly, comprehensive income closely approximates actual net income.

*Segment Reporting*

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

**3. RESTATEMENT OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS:**

*Background*

Based upon an investigation and determinations made by a Special Committee of its board of directors and management's undertaking of a separate review of historical stock option grant activity subsequent to the issuance of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, the Company identified errors in its accounting related to stock option compensation expenses in prior periods.

The Company announced on March 13, 2006 that a Special Committee of the board of directors was conducting an internal investigation of its practices related to stock option grants to officers, directors and employees, and related matters. The Special Committee was comprised of disinterested members of the Company's board of directors and was assisted by independent outside legal counsel and accounting experts.

On May 24, 2006, the Special Committee advised the board of directors of its final conclusion that, among other things, the recorded grant dates for certain stock option grants should not be relied upon. After receiving the Special Committee's conclusions and consistent with those conclusions, the Company reviewed stock option grants during the period from 1998 through June 2006. The Company developed and applied certain methodologies in accordance with APB 25 and FAS 123 in determining the revised measurement dates for stock option grants during the periods from 1998 through 2005. A description of the methodologies applied is discussed below. Stock options granted From January 1 to June 30, 2006 had no impact to the financial statements related to revised measurement dates.

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In addition to restatement adjustments for stock-based compensation expenses and the related income and payroll tax effects, the Company recorded adjustments to correct other errors that occurred in the periods ended December 31, 2001 through the third quarter of 2005.

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

The Company's accompanying restated condensed consolidated financial statements for the three and nine months ended September 30, 2005 incorporate adjustments related to stock-based compensation expense, payroll tax expense and other accounting adjustments, including the income tax effect of the restatement adjustments. The table below presents the effect of the individual restatement adjustments, which are explained in further detail following the table (in thousands):

|   | Three Months<br>Ended September | Nine Months<br>Ended September |
|---|---------------------------------|--------------------------------|
|   | 30, 2005                        | 30, 2005                       |
| <b>STOCK COMPENSATION:</b>  |                                 |                                |
| New hire non-officer stock option grants accounted for as being made prior to the terms being fixed | \$ 49                           | \$ 154                         |
| Stock option grants with insufficient or incomplete corporate approvals                             | 475                             | 1,704                          |
| Stock option grants cancelled and repriced  | 32                              | 389                            |
| Accelerated vesting and other matters related to stock-based compensation                           | (2)                             | 27                             |
| Total stock compensation expense  | 554                             | 2,274                          |
| Payroll taxes, interest and penalties   | 28                              | (226)                          |
| Total stock compensation related adjustments  | 582                             | 2,048                          |
| <b>OTHER MISCELLANEOUS ACCOUNTING ADJUSTMENTS:</b>  |                                 |                                |
| Correction of sales returns reserve   |                                 | 520                            |
| Correction of period of charge for cost of wafers used in engineering                               |                                 | (108)                          |
| Correction of expected life of tooling for depreciation purposes                                    | (64)                            | (64)                           |
| Total other miscellaneous accounting adjustments  | (64)                            | 348                            |
| Total adjustments to decrease income before income tax  | 518                             | 2,396                          |
| <b>INCOME TAX BENEFIT</b>   | <b>123</b>                      | <b>1,301</b>                   |
| Total adjustments to decrease net income  | \$ 395                          | \$ 1,095                       |
| <b>DECREASE IN EARNINGS PER DILUTED SHARE</b>   | <b>\$ 0.01</b>                  | <b>\$ 0.04</b>                 |

*Stock Compensation* These adjustments are from the Company's determination that the initially recorded measurement dates for various categories of option grants could not be relied upon. These categories included the following:

*New-hire non-officer stock option grants accounted for as being made prior to the terms being fixed.* The Company's practice was to set the exercise price of new-hire non-officer awards based upon the fair value of its stock on the employee's hire date or the last day of the month of the employee's first month of employment, whichever was lower. Because this determination was made at the end of the month of hire, the last day of the month of the employee's first month of employment was determined to be the first date when the number of shares and the price of each grant were known with finality. Grants accounted for as being made before the last day of the

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month of the employee's first month of employment (options to purchase an aggregate of 1,168,383 shares as of September 30, 2005) were accounted for as fixed awards under Accounting Principles Board Opinion (APB) No. 25 *Accounting for Stock Issued to Employees*, or APB 25.



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

*Stock option grants with insufficient or incomplete corporate approvals.* The Company determined that for certain stock option grants the number of shares and the exercise price were not known with finality at the original measurement date. The Company determined that the original recorded grant date could not be relied on because there was correspondence or other evidence that indicated that not all required corporate approvals had been obtained, including the finalization of the number of stock options allocated and the related exercise price. The Company adopted a methodology to remeasure these option grants to a revised measurement date, as described below, and accounted for these grants (options to purchase an aggregate of 6,350,639 shares as of September 30, 2005) as fixed awards under APB 25.

*Stock option grants determined to have been cancelled and repriced.* The Company determined that the terms of certain stock option grants (options to purchase an aggregate of 415,000 shares as of September 30, 2005) may have been communicated to employees and that those terms were subsequently modified. The Company concluded that such modifications constituted repricings and, therefore, that these stock option grants should have been accounted for as variable awards for accounting purposes.

*Accelerated vesting and other matters related to stock-based compensation.* Accelerated vesting consists primarily of the acceleration of stock option vesting (options to purchase an aggregate of 341,174 shares) upon termination of a few employees prior to 2001, which resulted in stock-based compensation expense which had previously not been recorded. The other matters relate primarily to the impact of the capitalization in inventory of stock-based compensation through September 30, 2005.

*Payroll taxes, interest and penalties* In connection with the stock-based compensation adjustments, the Company determined that certain options previously classified as Incentive Stock Option, or ISO, grants were determined to have been granted with an exercise price below the fair market value of the Company's stock on the revised measurement date (see discussion under Accounting Considerations below). Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant, and therefore these grants might not qualify for ISO tax treatment. The Company refers to these stock options as the Affected ISOs. The potential disqualification of ISO status exposes the Company to additional payroll related withholding taxes on the exercise of these Affected ISOs granted to U.S. employees, and penalties and interest for failing to properly withhold taxes on exercise of those options. The payroll taxes, interest and penalties were recorded as expenses in the periods in which the underlying stock options were exercised. Then, in subsequent periods in which the liabilities were legally extinguished due to statutes of limitations, the payroll taxes, interest and penalties were reversed, and recognized as a reduction in the related functional expense category in the Company's consolidated statements of operations. The fluctuations in the restatement adjustments in the table above are the result of: (1) the timing of stock option exercises, and (2) the reversals of expenses previously recorded due to the expiration of statutes of limitations. The net tax liability at September 30, 2006 for this potential disqualification of ISO tax treatment for option awards totaled \$0.7 million.

*Other miscellaneous accounting adjustments* In addition to stock-based compensation charges, the Company recorded adjustments related to prior periods that had not been previously reflected in its consolidated financial statements. These restatements relate primarily to a correction of the Company's sales return reserve, which should have been reduced in 2001. The Company also corrected the period of charge for certain wafers used in engineering, and corrected the expected life of tooling for depreciation purposes.

Further, the Company corrected the classification of the balance of auction rate securities (for which interest rates reset in 90 days or less, but for which the underlying maturity date is longer than 90 days), and callable securities (for which interest rates reset between 91 days and 1 year, but for which the underlying maturity date exceeds 1 year) from cash and cash equivalents or short-term investments to long-term investments, as of September 30, 2005. The condensed consolidated statement of cash flows for nine months ended September 30, 2005 was also corrected for the effects of the aforementioned restatements as well as to correct for the non-cash effects of property and equipment purchases recorded, but not yet paid for, at each period end.

*Income tax benefit* The Company reviewed the income tax effect of the stock-based compensation charges, and the Company believes that the proper income tax accounting for U.S. stock options under generally accepted accounting principles depends, in part, on the tax distinction of the stock options as either ISOs or non-qualified stock options, or NSOs. Although some of the Affected ISOs were originally intended to be ISOs, the Company noted that, under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant. Because of the potential impact of the measurement date changes on the qualified status of Affected ISOs, the Company has determined

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that all Affected ISOs might not be qualified ISOs under the tax regulations, and therefore should be accounted for as if they were NSO s for income tax accounting purposes.

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**POWER INTEGRATIONS, INC.**

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

Included in the income tax benefit on restatement adjustments for the nine months ended September 30, 2005, described above, the Company also recorded a separate income tax benefit adjustment of approximately \$692,000 during the quarter ended June 30, 2005. This adjustment was recorded to correct the timing of a correction of an error from 2003 in the determination of the effect of a cost sharing arrangement with one of the Company's subsidiaries. The Company originally recorded the correction in the quarter ended June 30, 2005. The adjustment error was reversed in the Company's restated financial statements as of June 30, 2005, which effectively reversed the prior correction which is now properly booked in the year ended 2003, as it related to the Company's 2003 tax liability.

The Company has recorded a net income tax benefit of approximately \$13.5 million in connection with the stock-based compensation related expense and other restatement adjustments during the period from fiscal year 1998 to September 30, 2005. This income tax benefit has resulted in an increase to the Company's deferred tax assets for all U.S. affected stock options prior to the exercise or forfeiture of the related options. The Company recorded no income tax benefit or deferred tax asset for affected stock options granted to non-U.S. employees because the Company determined that it could not receive tax benefits outside of the U.S. Further, the Company limited the deferred tax assets recorded for affected stock options granted to certain highly paid officers to reflect estimated limitations on tax deductibility under Internal Revenue Code Section 162(m). Upon exercise or forfeiture of the underlying options, the excess or deficiency in deferred tax assets are written-off to either expense or paid-in capital in the period of exercise or forfeiture.

The Company's board of directors has ratified each of the options granted, and the Company intends to honor each stock option granted pursuant to the terms of the applicable stock option plan and stock option agreement.

*Accounting Considerations - Stock-Based Compensation*

The Company originally accounted for all employee, officer and director stock option grants as fixed grants under APB 25, using a measurement date of the recorded grant date. The Company issued all grants with an exercise price equal to the fair market value of its common stock on the recorded grant date, and therefore originally recorded no stock-based compensation expense.

As a result of the Special Committee findings, and the Company's own further review of its stock option granting practices, the Company determined that the measurement dates for certain stock option grants differed from the recorded grant dates for such grants. In some instances, the Company was only able to locate sufficient evidence to identify the measurement date described in APB 25, the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known, within a possible range of dates. As a result, the Company developed a methodology to establish the revised measurement date primarily by using communication dates as its estimate of the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known with finality. Using the methodology described below the Company concluded that it was appropriate to revise the measurement dates for these grants based upon its findings, and the Company refers to these revised measurement dates as the *Deemed Measurement Dates*. The Company calculated stock-based compensation expense under APB 25 based upon the intrinsic value as of the Deemed Measurement Dates of stock option awards determined to be fixed under APB 25 and the vesting provisions of the underlying options. The Company calculated the intrinsic value on the Deemed Measurement Date as the closing price of its common stock on such date as reported on the Nasdaq National Market, now the Nasdaq Global Market, less the exercise price per share of common stock as stated in the underlying stock option agreement, multiplied by the number of shares subject to such stock option award. The Company recognizes these amounts as compensation expense over the vesting period of the underlying options (generally four years). The Company also determined that variable accounting treatment was appropriate under APB 25 for certain stock option grants to three officers for which evidence was obtained that the terms of the options may have been communicated to those officers and that those terms were subsequently modified (stock options cancelled and repriced). When variable accounting is applied to stock option grants, the Company remeasures, and reports in its consolidated statement of income, the intrinsic value of the options at the end of each reporting period until the options are exercised, cancelled or expire unexercised.

The methodology the Company used to determine the Deemed Measurement Dates associated with prior stock option grants was as follows:

*New Hire Non-Officer Employee Stock Options* The Company determined the Deemed Measurement Date for each of these grants to be the last day of the month of the employee's first month of employment. The Company's practice was to set the exercise price of these awards at the end of the month of hire, and therefore the Company determined that the last day of the month of the employee's first month of employment was the first date when the number of shares and the price of each grant were known with finality.



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**POWER INTEGRATIONS, INC.**

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

*All Other Stock Options* The Company determined the Deemed Measurement Date for each stock option grant, other than grants of new hire non-officer employee options, to be the Approval Date for the stock option, provided the Approval Date criteria set forth below were met. If the criteria for use of the Approval Date were not met, then the Company used the Communication Date, as defined below, as the Deemed Measurement Date for the stock option.

**Approval Date** The Approval Date was the date of approval set forth in executed minutes or a fully-executed consent of the board of directors, compensation committee or stock option committee documenting the grant of the stock option. However, the Company generally only used the Approval Date as the Deemed Measurement Date if both:

- (1) there was documentary evidence that the allocation of the shares had been finalized, and the written consent, if applicable, was executed, on that date ; and
- (2) the Communication Date for the stock option was within 30 days of the date of approval set forth in the documentary evidence.

**Communication Date** The Company defines the Communication Date as the date the Company determined the key terms of the option (both the number of shares and the exercise price) had initially been communicated to the optionee. In the absence of specific documentary evidence of initial communication, the Company generally determined the Communication Date to be the earliest of:

- (1) the date the employee record of the grant of the stock option was added to the stock option database application, or the latest recordation date in the case of a group of grants (the Record Add Date );
- (2) the optionee manual signature date on the stock option agreement, or the earliest optionee manual signature date in the case of a group of grants (the Stock Option Agreement Date ); and
- (3) for officers and directors, the date that a Form 3 or 4 was filed with the SEC with respect to the grant (the Form 3/4 Date ).

However, the Company did not consider the Record Add Date in its determination if the Stock Option Agreement Date was more than 30 days after the Record Add Date in the case of individual grants and grants to groups of less than five, or more than 10 days after the Record Add Date in the case of grants to groups of five or more. The Company made the distinction regarding small and large groups because the Company would expect to see at least one agreement returned to the Company within 10 days with larger groups of optionees; but with small groups, the probability of seeing an agreement returned to the Company within 10 days was less likely.

When applying this methodology to groups of grants, the Company generally determined the Communication Date for the group to be the latest Record Add Date, the earliest Stock Option Agreement Date, or Form 3/4 Dates as the Company determined that, under the Company's stock option grant process, the terms of stock options were communicated concurrently to each member of a group. The Company excluded a limited number of options, or Outliers, from the determination of the latest Record Add Date and the earliest Stock Option Agreement Date for a group of grants when, based upon available evidence, it considered the Outlier dates as not reliable as to the date that the terms of the stock option grants were communicated to the group.

*Outside Director Automatic Stock Option Grants*

The Company's 1997 Outside Directors Stock Option Plan provides for the automatic grant of stock options to its outside directors, such that the grants require no independent action of the Board or any committee of the Board. The Outside Directors Plan provides that each outside director is granted a stock option to purchase 30,000 shares of Power Integrations, Inc. common stock upon appointment as a member of the Board, and

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that each outside director is granted a stock option to purchase 10,000 shares of the Company's common stock at each anniversary of the date of appointment or,

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**POWER INTEGRATIONS, INC.**

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

in the case of outside directors appointed prior to the Company's initial public offering, the anniversary date of the initial public offering. The exercise price of each stock option grant is the fair market value of a share of common stock on the date of grant.

The Company has determined that, as a result of administrative errors, a total of 16 grants representing options to purchase 180,000 shares under the Outside Directors Plan collectively to three of the Company's outside directors were documented as having been made on dates other than as set forth in the Outside Directors Plan. The Company has corrected the documentation of these grants to reflect the correct dates and exercise prices, as automatically established under the Outside Directors Plan. Because these actions were corrections of administrative errors in the documentation, rather than changing any of the terms of the stock option grants as automatically granted, the Company determined that there was no accounting charge to be recognized in connection with these corrections, as the correct measurement date was the date of grant as automatically established by the Outside Directors Plan, and the exercise price was the fair market value of the Company's common stock on the correct measurement date.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Impact of the Restatement Adjustments on the Company's Condensed Consolidated Financial Statements*

The following tables present the impact of the financial statement restatement adjustments on the Company's previously reported condensed consolidated statements of income for the three and nine months ended September 30, 2005, and the condensed consolidated statement of cash flows for the nine months ended September 30, 2005 (in thousands):

|  | Three Months Ended           |             |      |                | Nine Months Ended            |             |       |                |
|--|------------------------------|-------------|------|----------------|------------------------------|-------------|-------|----------------|
|  | September 30, 2005           |             |      |                | September 30, 2005           |             |       |                |
|  | As<br>Previously<br>Reported | Adjustments |      | As<br>Restated | As<br>Previously<br>Reported | Adjustments |       | As<br>Restated |
| NET REVENUES                             | \$ 36,543                    | \$          |      | \$ 36,543      | \$ 106,258                   | \$ (1,062)  | B     | \$ 105,196     |
| COST OF REVENUES                         | 18,463                       | 24          | A, D | 18,487         | 54,287                       | (292)       | A,B,D | 53,995         |
| GROSS PROFIT                             | 18,080                       | (24)        |      | 18,056         | 51,971                       | (770)       |       | 51,201         |
| OPERATING EXPENSES:                      |                              |             |      |                |                              |             |       |                |
| Research and development                 | 4,105                        | 168         | A    | 4,273          | 12,307                       | 446         | A,E   | 12,753         |
| Sales and marketing                      | 4,418                        | 155         | A    | 4,573          | 12,699                       | 490         | A     | 13,189         |
| General and administrative               | 4,092                        | 156         | A    | 4,248          | 9,802                        | 729         | A     | 10,531         |
| Total operating expenses                 | 12,615                       | 479         |      | 13,094         | 34,808                       | 1,665       |       | 36,473         |
| INCOME FROM OPERATIONS                   | 5,465                        | (503)       |      | 4,962          | 17,163                       | (2,435)     |       | 14,728         |
| OTHER INCOME, NET                        | 939                          | (15)        | A    | 924            | 2,318                        | 40          | A     | 2,358          |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 6,404                        | (518)       |      | 5,886          | 19,481                       | (2,395)     |       | 17,086         |
| PROVISION FOR INCOME TAXES               | 739                          | (123)       | A    | 616            | 4,034                        | (1,300)     | A,C   | 2,734          |
| NET INCOME                               | \$ 5,665                     | \$ (395)    |      | \$ 5,270       | \$ 15,447                    | \$ (1,095)  |       | \$ 14,352      |
| EARNINGS PER SHARE:                      |                              |             |      |                |                              |             |       |                |
| Basic                                    | \$ 0.19                      | \$ (0.01)   |      | \$ 0.18        | \$ 0.52                      | \$ (0.04)   |       | \$ 0.48        |
| Diluted                                  | \$ 0.18                      | \$ (0.01)   |      | \$ 0.17        | \$ 0.50                      | \$ (0.04)   |       | \$ 0.46        |
| SHARES USED IN PER SHARE CALCULATION:    |                              |             |      |                |                              |             |       |                |
| Basic                                    | 29,478                       |             |      | 29,478         | 29,605                       |             |       | 29,605         |



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|         |        |     |        |        |     |        |
|---------|--------|-----|--------|--------|-----|--------|
| Diluted | 30,732 | 117 | 30,849 | 30,760 | 130 | 30,890 |
|---------|--------|-----|--------|--------|-----|--------|

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- A: Adjustment for stock-based compensation expense pursuant to APB No. 25 and the associated payroll taxes, interest, penalties and income tax benefit.
  - B: Adjustment to correct the sales return reserve.
  - C: Adjustment to correct for an error in the calculation under a cost sharing agreement with a subsidiary company.
  - D: Adjustment to correct the expected life of tooling for depreciation purposes.
  - E: Adjustment to correct for the period of charge for engineering wafers.

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

|   | Nine Months Ended         |             |                    |           |
|---|---------------------------|-------------|--------------------|-----------|
|   | As Previously<br>Reported | Adjustments | September 30, 2005 |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                           |             |                    |           |
| Net income  | \$ 15,447                 | \$ (1,095)  |                    | \$ 14,352 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |             |                    |           |
| Depreciation and amortization   | 4,930                     | (191)       | F                  | 4,739     |
| Stock-based compensation expense  | 8                         | 2,273       | A                  | 2,281     |
| Deferred income taxes   | (10)                      | 144         | A                  | 134       |
| Provision for (reduction in) accounts receivable and other allowances             | 76                        | 367         | B                  | 443       |
| Tax benefit associated with employee stock plans                                  | 1,007                     | (312)       | A                  | 695       |
| Change in operating assets and liabilities:                                       |                           |             |                    |           |
| Accounts receivable   | (2,595)                   | 153         |                    | (2,442)   |
| Inventories   | 3,054                     | 128         | F                  | 3,182     |
| Prepaid expenses and other assets   | 1,298                     |             |                    | 1,298     |
| Accounts payable  | (2,242)                   | 306         | A,C,D              | (1,936)   |
| Taxes payable and other accrued liabilities                                       | 1,061                     | (1,427)     | A,G                | (366)     |
| Deferred income on sales to distributors  | (56)                      |             |                    | (56)      |
| Net cash provided by operating activities   | 21,978                    | 346         |                    | 22,324    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                           |             |                    |           |
| Purchases of property and equipment   | (2,270)                   | (346)       | D                  | (2,616)   |
| Acquisition of technology patents / licenses                                      | (1,094)                   |             |                    | (1,094)   |
| Note to supplier  | (10,000)                  |             |                    | (10,000)  |
| Purchases of held-to-maturity investments   | (6,806)                   |             |                    | (6,806)   |
| Proceeds from maturities of held-to-maturity investments                          | 11,271                    |             |                    | 11,271    |
| Net cash used in investing activities   | (8,899)                   | (346)       |                    | (9,245)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                           |             |                    |           |
| Net proceeds from issuance of common stock  | 6,973                     |             |                    | 6,973     |
| Repurchase of common stock  | (28,305)                  |             |                    | (28,305)  |
| Net cash used in financing activities   | (21,332)                  |             |                    | (21,332)  |
| NET DECREASE IN CASH AND CASH EQUIVALENTS   | (8,253)                   |             |                    | (8,253)   |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD                                  | 108,396                   | (1,000)     | E                  | 107,396   |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD  | \$ 100,143                | \$ (1,000)  |                    | \$ 99,143 |

- A: Adjustment for stock-based compensation expense pursuant to APB No. 25 and the associated payroll taxes, interest, penalties and income tax benefit.
- B: Adjustment to correct the sales return reserve.
- C: Adjustment to correct for the period of charge for engineering wafers.
- D: Adjustment for unpaid property and equipment purchases
- E: Reclassification of auction rate and callable securities.

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- F. Adjustment to correct the expected life of tooling for depreciation purposes.
- G. Adjustment to correct for an error in the calculation under a cost sharing agreement with a subsidiary company.

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. STOCK PLANS AND STOCK-BASED COMPENSATION:****Stock Plans**

As of September 30, 2006, the Company had four stock-based employee compensation plans, the Plans, which are described below.

*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 may grant incentive stock options and non-qualified stock options to key employees, directors and consultants. The exercise price of incentive stock options may not be less than 100% of the fair market value of the Company's common stock on the date of grant. The exercise price of non-qualified stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. The 1997 Plan originally provided that the number of shares reserved for issuance automatically increased on each January 1st, from January 1, 1999 through January 1, 2007, by 5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. In January 2005, the board of directors amended the 1997 Plan to reduce the annual increase from 5% to 3.5%, so that the number of shares reserved for issuance automatically increase on each January 1st, from January 1, 2006 through January 1, 2007, by 3.5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. As of September 30, 2006 the maximum number of shares that may be issued under the 1997 Plan was 14,085,792. In general, options vest over 48 months. Options generally expire no later than ten years after the date of grant (five years if an incentive stock option is granted to a ten percent owner optionee), subject to earlier termination upon an optionee's cessation of employment or service.

*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 Directors plan is designed to work automatically without administration; however, to the extent administration is necessary, it will be performed by the board of directors. The Directors Plan provides for the automatic grant of nonstatutory stock options to nonemployee directors of the Company over their period of service on the board of directors. The Directors Plan provides that each future nonemployee director of the Company will be granted an option to purchase 30,000 shares of common stock on the date 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). Subject to an optionee's continuous service with the Company, approximately 1/3<sup>rd</sup> of an Initial Grant will become 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. 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. 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.

*1998 Nonstatutory Stock Option Plan*

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the 1998 Plan), whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to the extent that such options do not require approval of the Company's stockholders. The 1998 Plan has not been approved by the Company's stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. As of September 30, 2006, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000 shares. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

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**POWER INTEGRATIONS, INC.**

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

*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 two-year offering period, or (ii) the fair market value of the Company's common stock on the semi-annual purchase date. If the fair market value of the Company's common stock on any semi-annual purchase date within a two-year offering period is less than the fair market value per share on the first day of such offering period, then immediately following purchase of shares of the Company's common stock on that semi-annual purchase date, participants will be automatically withdrawn from the offering period and enrolled in a new two-year offering period beginning immediately thereafter. An aggregate of 2,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of September 30, 2006, 1,609,300 shares had been purchased and 390,700 shares were reserved for future issuance under the Purchase Plan. In April 2006 the Company temporarily suspended the Purchase Plan due to the Company's delisted status with the NASDAQ.

**Stock-Based Compensation**

Effective January 1, 2006, the Company adopted the fair-value recognition provisions of Statement of Financial Accounting Standards, (SFAS 123R) *Share-Based Payment*. The Company previously applied Accounting Principles Board (APB) opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations, and provided pro forma disclosures of SFAS 123, *Accounting for Stock-Based Compensation*. The Company has elected to use the modified prospective transition method, as provided by SFAS 123R. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2006 includes; compensation in connection with the unvested portion of all stock-based compensation awards that were granted prior to January 1, 2006, and compensation related to all stock option awards granted subsequent to December 31, 2005. The Company is using the accelerated method to amortize options granted through December 31, 2005 over the remaining requisite service period of the stock option award, and the straight-line method for all stock options granted after December 31, 2005 over the requisite service period of the award. In accordance with SFAS 123R, as of January 1, 2006, all deferred compensation previously recorded has been eliminated with a corresponding reduction in additional paid in capital.

As of September 30, 2006 there was approximately \$23 million, net of expected forfeitures, of total unrecognized compensation costs related to stock options, and \$11.8 million was recorded as stock compensation expense in the nine months ended September 30, 2006. The unrecognized compensation costs are expected to be recognized over a weighted average period of 2.05 years.

*Determining Fair Value*

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

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

*Expected Life.* The Company uses the simplified method to calculate the expected life of stock option grants. This method assumes all options will be exercised midway between the vesting date and the contractual term of the option.

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

*Dividends.* The Company has not paid dividends in the past, nor does it have any current plans to pay dividends. As such, the Company uses a dividend yield percentage of zero.

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



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

|  | Three Months Ended September 30, |                     | Nine Months Ended September 30, |                     |
|--|----------------------------------|---------------------|---------------------------------|---------------------|
|  | 2006                             | 2005<br>As restated | 2006                            | 2005<br>As restated |
| Risk-free interest rates               | 4.85%                            | 3.76% - 4.35%       | 4.46% - 5.00%                   | 2.98% - 4.35%       |
| Expected volatility rates              | 49%                              | 62.32% - 82.42%     | 49% - 52%                       | 62.32% - 85.01%     |
| Expected dividend yield As reported    |                                  |                     |                                 |                     |
| Expected life of stock options (years) | 6.03                             | 6.03                | 6.03                            | 6.03                |

|   |         |          |          |          |
|---|---------|----------|----------|----------|
| Weighted-average grant date fair value of options granted | \$ 8.45 | \$ 15.94 | \$ 13.20 | \$ 12.97 |
|---|---------|----------|----------|----------|

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

|  | Three Months Ended September 30, |                        | Nine Months Ended September 30, |                        |
|--|----------------------------------|------------------------|---------------------------------|------------------------|
|  | 2006                             | 2005<br>As<br>restated | 2006                            | 2005<br>As<br>restated |
| Risk-free interest rates (1)                             |                                  | 3.69%                  | 4.44%                           | 3.69%                  |
| Expected volatility rates (1)                            |                                  | 42%                    | 37%                             | 42%                    |
| Expected dividend yield As reported                      |                                  |                        |                                 |                        |
| Expected life of purchase right (years)                  |                                  | 1.0                    | 1.0                             | 1.0                    |
| Weighted-average estimated fair value of purchase rights | \$ 6.81                          | \$ 7.91                | \$ 6.81                         | \$ 8.94                |

(1) In the three months ended September 30, 2006 the assumptions used for the risk-free interest rate and expected volatility rate were not applicable, as a result of the suspension of the Company's employee stock purchase plan due to the Company's delisted status with the SEC. The following table summarizes the stock-based compensation expense related to stock options and employee stock purchases for the three and nine months ended September 30, 2006, recognized in accordance with SFAS 123R, and for the three and nine months ended September 30, 2005, recognized in accordance with APB 25 (in thousands).

|   | Three Months       |                        | Three Months      |                        |
|---|--------------------|------------------------|-------------------|------------------------|
|   | Three Months Ended | Three Months Ended     | Nine Months Ended | Nine Months Ended      |
|   | Sept 30,           | Sept 30,               | Sept 30,          | Sept 30,               |
|   | 2006               | 2005<br>As<br>restated | 2006              | 2005<br>As<br>restated |
| Stock-based compensation expense for stock options and employee stock purchases included in operations: |                    |                        |                   |                        |
| Cost of sales   | \$ 448             | \$ 84                  | \$ 907            | \$ 318                 |
| Research and development  | 1,019              | 165                    | 3,336             | 685                    |
| Sales and marketing   | 1,311              | 150                    | 4,274             | 531                    |
| General and administrative  | 1,045              | 156                    | 3,306             | 747                    |
| Total stock-based compensation expense  | \$ 3,823           | \$ 555                 | \$ 11,823         | \$ 2,281               |





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

A summary of option activity under the Plans as of September 30, 2006, and changes during the nine months then ended, is presented below:

|   | Shares<br>(in thousands) | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value (in<br>thousands) |
|---|--------------------------|---|--|---|
| Outstanding at January 1, 2006                    | 7,570                    | \$ 19.09                                  |  |   |
| Granted   | 1,401                    | 24.79                                     |  |   |
| Exercised   | (294)                    | 14.45                                     |  |   |
| Forfeited or expired                              | (196)                    | 22.89                                     |  |   |
| Outstanding at September 30, 2006                 | 8,481                    | \$ 20.17                                  | 6.36                                       | \$ 20,763   |
| Exercisable at September 30, 2006                 | 5,645                    | \$ 18.96                                  | 5.32                                       | \$ 18,338   |
| Vested and expected to vest at September 30, 2006 | 8,116                    | \$ 20.06                                  | 6.26                                       | \$ 20,471   |

The weighted-average grant-date fair value of options granted for the three and nine months ended September 30, 2006 was \$8.45 and \$13.20, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was \$166,648 and \$3.4 million, respectively.

The pro forma net income and earnings per share for the three and nine months ended September 30, 2005 have been presented below to reflect the impact had the Company been required to include the amortization of the option fair values in accordance with SFAS 123 as an expense. The pro forma amounts are as follows (in thousands except per share information):

|  | Three<br>Months<br>Ended<br>September 30,<br>2005<br>As restated | Nine Months<br>Ended<br>September 30,<br>2005<br>As restated |
|--|--|--|
| Net income as reported   | \$ 5,270   | \$ 14,352  |
| Add: Total stock-based expense included in reported net earnings, net of related tax effects                                   | 405  | 1,715  |
| Deduct: Total stock-based employee stock ownership expense determined under fair-value-based method for all awards, net of tax | (4,228)  | (13,338)   |

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|                                    |    |       |    |       |
|------------------------------------|----|-------|----|-------|
| Pro forma net income               | \$ | 1,447 | \$ | 2,729 |
| <b>Basic earnings per share:</b>   |    |       |    |       |
| As reported                        | \$ | 0.18  | \$ | 0.48  |
| Pro forma                          | \$ | 0.05  | \$ | 0.09  |
| <b>Diluted earnings per share:</b> |    |       |    |       |
| As reported                        | \$ | 0.17  | \$ | 0.46  |
| Pro forma                          | \$ | 0.05  | \$ | 0.09  |

**5. INVENTORIES:**

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

|                 | <b>September 30,</b> | <b>December 31,</b> |
|-----------------|----------------------|---------------------|
|                 | <b>2006</b>          | <b>2005</b>         |
| Raw materials   | \$ 5,650             | \$ 1,683            |
| Work-in-process | 8,163                | 6,431               |
| Finished goods  | 13,046               | 9,815               |
|                 | \$ 26,859            | \$ 17,929           |

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. INTANGIBLE ASSETS:**

Intangible assets consist primarily of acquired licenses and patent rights and are reported net of accumulated amortization. The Company amortizes the cost of intangible assets over the term of the acquired license or patent rights, which ranges from five to twelve years. Amortization for all acquired intangible assets was approximately \$0.2 million and \$0.5 in the three and nine months ended September 30, 2006, respectively. The Company does not believe there is any significant residual value associated with the following intangible assets:

| <b>Intangible Asset Class</b>  | <b>Carrying Amount</b> | <b>Accumulated Amortization</b> | <b>Net Intangible Value</b> |
|--------------------------------|------------------------|---------------------------------|-----------------------------|
|                                | <b>Sept 30,</b>        | <b>Sept 30,</b>                 | <b>Sept 30,</b>             |
|                                | <b>2006</b>            | <b>2006</b>                     | <b>2006</b>                 |
|                                | <b>(in thousands)</b>  | <b>(in thousands)</b>           | <b>(in thousands)</b>       |
| Patent rights                  | \$ 3,165               | \$ 887                          | \$ 2,278                    |
| Technology licenses            | \$ 4,056               | \$ 273                          | \$ 3,783                    |
| Other intangibles              | \$ 38                  | \$ 10                           | \$ 28                       |
| <b>Total Intangible Assets</b> | <b>\$ 7,259</b>        | <b>\$ 1,170</b>                 | <b>\$ 6,089</b>             |

The estimated future amortization expense related to intangible assets at September 30, 2006 is as follows:

| <b>Fiscal Year</b>        | <b>Estimated Amortization (in thousands)</b> |
|---------------------------|--|
| 2006 (remaining 3 months) | \$ 194                                       |
| 2007                      | \$ 774                                       |
| 2008                      | \$ 774                                       |
| 2009                      | \$ 763                                       |
| 2010                      | \$ 728                                       |
| Thereafter                | \$ 2,856                                     |
| <b>Total</b>              | <b>\$ 6,089</b>                              |

**7. SIGNIFICANT CUSTOMERS AND EXPORT SALES:***Customer Concentration*

The Company's revenue is derived primarily from sales of its ICs to OEMs, power supply merchants and distributors. Ten customers accounted for approximately 66% and 69% of total net revenues for the three months ended September 30, 2006 and 2005, respectively, and 58% and 70% of the total net revenues for the nine months ended September 30, 2006 and 2005, respectively. A significant portion of these net revenues are attributable to sales of the Company's products through 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. In the nine months ended September 30, 2006, one customer, a distributor of the Company's products, accounted for more than 10% of net revenues, and in the same period in 2005, two

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customers, both of which were distributors of the Company's products, accounted for more than 10% of net revenues.

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

| Customer | Three Months Ended |                     | Nine Months Ended |                     |
|----------|--------------------|---------------------|-------------------|---------------------|
|          | September 30,      |                     | September 30,     |                     |
|          | 2006               | 2005<br>As restated | 2006              | 2005<br>As restated |
| A        | 26%                | 19%                 | 21%               | 20%                 |
| B        | *                  | 18%                 | *                 | 18%                 |

\* less than 10%

**Table of Contents****POWER INTEGRATIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***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 credit evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. As of September 30, 2006 and December 31, 2005, approximately 64% and 69% of accounts receivable, respectively, were concentrated with the top ten customers.

The following customers, both of which are distributors of the Company's products, accounted for more than 10% of accounts receivable:

| Customer | September 30,<br>2006 | December 31,<br>2005 |
|----------|-----------------------|----------------------|
| A        | 16%                   | 11%                  |
| B        | *                     | 18%                  |

\* less than 10%

*Export Sales*

The Company markets its products in North America and in foreign countries through its sales personnel and a worldwide network of independent sales representatives and distributors. As a percentage of total net revenues, export sales, which consist of domestic and foreign sales to customers in foreign countries, are comprised of the following:

|                                    | Three Months Ended    |                                      | Nine Months Ended     |                                      |
|------------------------------------|-----------------------|--------------------------------------|-----------------------|--------------------------------------|
|                                    | September 30,<br>2006 | September 30,<br>2005<br>As restated | September 30,<br>2006 | September 30,<br>2005<br>As restated |
| Hong Kong/China                    | 41%                   | 24%                                  | 30%                   | 24%                                  |
| Korea                              | 17%                   | 19%                                  | 19%                   | 20%                                  |
| Taiwan                             | 11%                   | 27%                                  | 17%                   | 26%                                  |
| Western Europe (excluding Germany) | 9%                    | 12%                                  | 10%                   | 11%                                  |
| Germany                            | 6%                    | 4%                                   | 5%                    | 4%                                   |
| Japan                              | 4%                    | 4%                                   | 4%                    | 4%                                   |
| Singapore                          | 4%                    | 2%                                   | 3%                    | 3%                                   |
| Other                              | 1%                    | 1%                                   | 4%                    | 2%                                   |
| Total foreign revenue.             | 93%                   | 93%                                  | 92%                   | 94%                                  |

*Product Sales*

Sales of the Company's TOPSwitch and TinySwitch products accounted for 89.9% and 93.7% of net revenues from product sales for the three months ended September 30, 2006 and 2005, respectively, and 89.3% and 95.2% of net revenues from product sales for the nine months ended

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September 30, 2006 and 2005, respectively. TOPSwitch products include TOPSwitch, TOPSwitch-II, TOPSwitch-FX and TOPSwitch-GX. TinySwitch products include TinySwitch,

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

TinySwitch-II, TinySwitch-III and PeakSwitch. The remaining 10.1% and 6.3% of net product sales in the three months ended September 30, 2006 and 2005, respectively, and the remaining 10.7% and 4.8% of net product sales in the nine months ended September 30, 2006 and 2005, respectively, was comprised primarily of sales of the Company's LinkSwitch and DPA-Switch products.

**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 consists of dilutive shares issuable upon the exercise of outstanding common stock options, 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    |                                      | Nine Months Ended     |                                      |
|--|-----------------------|--------------------------------------|-----------------------|--------------------------------------|
|  | September 30,<br>2006 | September 30,<br>2005<br>As Restated | September 30,<br>2006 | September 30,<br>2005<br>As Restated |
| <b>Basic earnings per share:</b>       |                       |                                      |                       |                                      |
| Net income                             | \$ 2,661              | \$ 5,270                             | \$ 6,388              | \$ 14,352                            |
| Weighted average common shares         | 28,650                | 29,478                               | 29,192                | 29,605                               |
| Basic earnings per share               | \$ 0.09               | \$ 0.18                              | \$ 0.22               | \$ 0.48                              |
| <b>Diluted earnings per share:</b>     |                       |                                      |                       |                                      |
| Net income                             | \$ 2,661              | \$ 5,270                             | \$ 6,388              | \$ 14,352                            |
| Weighted average common shares         | 28,650                | 29,478                               | 29,192                | 29,605                               |
| <b>Effect of dilutive securities:</b>  |                       |                                      |                       |                                      |
| Stock options                          | 1,182                 | 1,362                                | 1,695                 | 1,266                                |
| Employee stock purchase plan           |                       | 9                                    |                       | 19                                   |
| Diluted weighted average common shares | 29,832                | 30,849                               | 30,887                | 30,890                               |
| Diluted earnings per share             | \$ 0.09               | \$ 0.17                              | \$ 0.21               | \$ 0.46                              |

Options to purchase 5,260,244 and 1,900,775 shares of the Company's common stock outstanding for the three month periods ended September 30, 2006 and 2005, respectively, and options to purchase 3,579,907 and 1,954,281 shares of the Company's common stock outstanding for the nine month periods ended September 30, 2006 and 2005, respectively, were not included in the computation of diluted earnings per share for the periods then ended because the exercise prices of the options to purchase shares of Company common stock were greater than the average market price of the Company's common stock during those periods and, therefore, their effect would have been antidilutive.

**9. PROVISION FOR INCOME TAXES:**

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the provisions of SFAS 109, 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.

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. The difference between the expected federal statutory rate of 35% and the Company's effective tax rate of approximately 4% and 8%, for the three and nine-month periods ended September 30, 2006, respectively, was primarily due to the beneficial impact of international sales subject to lower tax rates, lower taxable income recorded in higher tax rate jurisdictions caused by increased expenses incurred in connection with the Company's previously announced investigation into its historical stock option practices and the resulting restatements of its prior financial statements, and research and development credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees. The difference between the expected federal statutory rate of 35% and the Company's effective tax rates for the three and nine month periods ended September 30, 2005, was primarily due to the beneficial impact of international sales subject to lower tax rates and research and development credits. The annual effective income tax rate may change in future periods.



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**POWER INTEGRATIONS, INC.**

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

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 hardware is found to infringe upon a patent, copyright, trademark, or other proprietary right of a third party (Customer Indemnification). The DSA generally limits the scope of and remedies for the Customer Indemnification obligations in a variety of industry-standard respects, including, but not limited to, limitations based on time and geography, and a right to replace an infringing product. The Company also, from time to time, has granted a specific indemnification to individual customers.

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of September 30, 2006. 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 the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. See note 12 below. In accordance with SFAS No. 5, *Accounting for Contingencies*, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

**12. LEGAL PROCEEDINGS:**

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (System General), a Taiwanese company, and its U.S. subsidiary. The complaint alleges that certain integrated circuits produced by System General infringed and continue to infringe certain of its patents. The Company seeks, among other things, an order enjoining System General from infringing its patents and an award for damages resulting from the alleged infringement. On June 10, 2005, in response to the initiation of the U.S. International Trade Commission ( ITC ) investigation (discussed below), the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay. On December 6, 2006, System General filed a notice of appeal of the ITC decision as discussed below. In response, and by agreement of the parties, the District Court renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination.

On May 9, 2005, the Company filed a Complaint with the ITC under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337. The Company filed a supplement to the complaint on May 24, 2005. The Company alleged infringement of certain of its patents pertaining to pulse width modulation ( PWM ) integrated circuit devices. The Commission instituted an investigation on June 8, 2005 in response to the Company's complaint. System General Corporation 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. 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

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the infringing products as well as certain downstream products that contain the infringing products. On June 30, 2006 the Commission decided not to review the initial determination on

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**POWER INTEGRATIONS, INC.**

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

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 Systems General PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing Systems General chip. The U.S. Customs Service is authorized to enforce the exclusion order which is now in full effect. On December 6, 2006 System General filed a notice of appeal of the ITC decision. Briefing has been completed, and the appeal will be heard by the U.S. Court of Appeals for the Federal Circuit in coming months.

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 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, and the Company will request the damages to be enhanced in view of the jury's finding on willfulness, 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 has raised defenses contending that the asserted patents are invalid or unenforceable, and the court set a second trial on these issues to begin on September 17, 2007.

On April 11, 2006, Fairchild Semiconductor Corporation and Intersil Corporation filed a patent infringement lawsuit against the Company in the U.S. District Court for the Eastern District of Texas. The complaint asserts that the Company infringed on an old Intersil patent that Fairchild recently secured exclusive rights to assert against the Company but Fairchild and Intersil did not identify any specific products they believe infringe the patent. Fairchild and Intersil's lawsuit is flawed because both Fairchild and Intersil lack standing to sue the Company and it is also duplicative of a portion of the Company's suit against Fairchild in Delaware, and the Company therefore filed a motion addressing both issues. The Texas Court granted the Company's motion to transfer the case to Delaware on March 6, 2007, and the case has been transferred to Delaware and assigned to Judge Farnan, the presiding judge in the Fairchild case discussed above. The Delaware Court has scheduled a status conference for August 2, 2007, but there have been no further developments in the case. The Company continues to believe Fairchild's case should be dismissed for lack of standing, or in the alternative, be stayed pending the outcome of the trial against Fairchild later this year. In either case, the Company does not expect Fairchild's suit to have any impact on its lawsuit against Fairchild.

On June 14, 2007, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. subsidiary. The complaint alleges that certain integrated circuits produced by BCD infringe certain of the Company's patents. The Company seeks, among other things, an order enjoining BCD from infringing its patents and an award for damages resulting from the alleged infringement. BCD has not yet answered the complaint.

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of Power Integrations, against certain of Power Integrations' current and former executives and members of its board of directors relating to the Company's historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco's counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. The consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of Power Integrations' shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. On July 20, 2007, the parties entered a stipulation by which the plaintiffs would file an amended complaint on or before August 1, 2007. Pursuant to the stipulation, Power Integrations' response to the amended complaint will be due on September 10, 2007.



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**POWER INTEGRATIONS, INC.**

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

On May 26, 2006, Stanley Banko, an alleged shareholder, filed a derivative complaint in the Superior Court of California, Santa Clara County, purportedly on behalf of Power Integrations, against certain of the Company's current and former executives and members of Power Integrations board of directors relating to its historical stock option granting practices. On May 30, 2006, Joan Campbell, also an alleged shareholder, filed a derivative suit in the Superior Court of California, Santa Clara County, making the identical allegations asserted in the Banko lawsuit. On June 30, 2006, pursuant to a stipulation by the parties, the Court consolidated the two cases into a single proceeding and required plaintiffs to file an amended, consolidated complaint. Plaintiffs filed their consolidated complaint on August 14, 2006, in which plaintiffs named additional officers and former officers and KPMG LLP, Power Integrations' former auditor, as new defendants. The consolidated complaint alleges, among other things, that the defendants caused or allowed Power Integrations' executives to manipulate their stock option grant dates, that defendants improperly backdated stock option grants, and that costs associated with the stock option grants were not properly recorded in Power Integrations' financial statements. The complaint asserts claims for, among other things, insider trading, breach of fiduciary duty, gross mismanagement and unjust enrichment. On September 15, 2006, the Court stayed this action until January 19, 2007. The parties have filed a stipulation to extend the stay until October 5, 2007.

On May 23, 2006, the U.S. Attorney's Office for the Northern District of California, or DOJ, issued a grand jury subpoena to the Company directing that it produce documents relating to the granting of stock options from 1995 through the present. On May 31, 2006, the staff of the Securities and Exchange Commission, or SEC, sent a letter to the Company directing it to take appropriate actions to preserve certain documents relating to its stock option practices. Since that time, the government has made a number of requests for the Company to voluntarily produce documents relating to, among other things, the Company's stock option practices. In addition, the government has been conducting voluntary interviews of certain current and former officers and employees. The Company believes it is cooperating fully with the SEC and the DOJ and has stated its intent to continue to do so.

The Internal Revenue Service, or IRS, is conducting an audit of the Company's 2002 and 2003 tax returns. The IRS has issued a number of Notices of Proposed Adjustment to these returns. Among other things, the IRS has challenged several aspects of the Company's research and development cost-sharing arrangement, which was put into place on November 1, 2003. While the Company has agreed to some of the adjustments proposed by the IRS, it disputes other proposed adjustments.

There can be no assurance that the Company will prevail in its litigation with System General, Fairchild or BCD. This litigation, whether or not determined in the Company's 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 its business, financial condition and operating results. In addition, the Company is unable to predict the outcome of the other legal proceedings described above. Adverse determinations in litigation could result in monetary losses, the loss of the Company's proprietary rights, subject the Company to significant liabilities, require the Company to seek licenses from third parties or prevent the Company from licensing its technology, any of which could have a material adverse effect on the Company's business, financial condition and operating results.

**13. DISTRIBUTOR PRICING CREDIT RECOVERY**

In April 2006, the Company recorded \$3.4 million in revenue related to a settlement agreement negotiated with one of its distributors. The Company performed an audit of distributor pricing credit requests, and discovered discrepancies in the supporting documentation the distributor supplied during such audit. In April 2006, this distributor reimbursed the Company \$3.4 million for discrepant credits which had previously been granted by the Company. The Company has subsequently cancelled its distributor relationship with this customer in the second quarter of 2006.

**14. PREPAYMENT TO A SUPPLIER TO SECURE WAFER MATERIAL**

The Company entered into a wafer supply agreement amendment with its foundry, ZMD, which amends its previous agreement with the Company. The amended agreement includes a Company prepayment of \$2.3 million to ZMD for raw materials. ZMD secured the raw material for use in the production of the Company's wafers. The Company included the prepayment in prepaid expenses and other current assets in its September 30, 2006 condensed consolidated balance sheet.



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**POWER INTEGRATIONS, INC.**

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

**15. RECENT ACCOUNTING PRONOUNCEMENTS:**

Updates to recent accounting standards as disclosed in the Company's Form 10-K for the year ended December 31, 2005 are as follows:

In February 2007, the Financial Accounting Standards Board, or FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, the Company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an instrument-by-instrument basis, even though the Company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by the Company in the first quarter of 2008. The Company is currently determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, that SFAS 159 will have on the Company's consolidated results of operations and financial condition.

During the first quarter of 2006 the Company adopted FASB Staff Position (FSP) No. 115-1, (FAS) 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The adoption of this accounting pronouncement had no impact on the Company's financial statements.

**16. SUBSEQUENT EVENTS:**

*NASDAQ Delisting*

In 2006, the Company received two NASDAQ Staff Determination stating that the Company was not in compliance with Marketplace Rule 4310(c)(14) because the Company had not timely filed its Form 10-K for the year ended December 31, 2005 and Form 10-Q for the quarter ended March 31, 2006 and that, as a result, the Company's securities were subject to delisting from the NASDAQ Stock Market.

On May 2, 2006, and June 10, 2006, the Company received exceptions to the filing requirements and was granted extensions to file the required SEC filings by August 2, 2006. The Company formally notified NASDAQ on July 31, 2006 that it would not be able to meet this deadline. Accordingly, the Company's common stock was delisted on August 2, 2006 and the Company's shares then began trading on the Pink Sheets under the symbol POWI.PK .

On October 30, 2006, the suspension of trading of the Company's shares on NASDAQ was lifted, with continued trading contingent upon the Company filing its 2005 Form 10-K and Forms 10-Q for the quarters ended March 31, June 30 and September 30, 2006 by December 18, 2006. The Company did not meet this deadline and, as a result, the Company's shares were again delisted from NASDAQ as of December 19, 2006 and resumed trading on the Pink Sheets under the symbol POWI.PK .

*Commitments and Contingencies*

On October 26, 2006, the Company entered into a security agreement with Union Bank of California, whereby it agreed to maintain \$1.3 million in an interest-bearing certificate of deposit with the bank. The purpose of this agreement is to secure the commercial letters of credit and standby letters of credit. This agreement remains in effect until cancellation of the Company's letters of credit.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. *The following management's discussion and analysis of financial condition and results of operations, which gives effect to the restatement discussed in note 3 to the condensed consolidated financial statements, should be read in conjunction with management's discussion and analysis of financial condition and results of operations included in our Form 10-K for the year ended December 31, 2005. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A Risk Factors and elsewhere in this report.*

### **Overview**

We design, develop, manufacture and market proprietary, high-voltage, analog integrated circuits (ICs) for use primarily in electronic power supplies, also known as switched-mode power supplies or switchers. These ICs and the power supplies incorporating them are used in a wide variety of electronic products primarily in the consumer, communications, computer and industrial electronics markets.

Our ICs are purchased primarily by merchant power supply manufacturers who sell power supplies to OEMs, and, in some cases, by OEMs who design and build their own power supplies. In the nine months ended September 30, 2006, approximately 61% of our net sales to these end customers were made through distributors of electronic components. Power supplies may be designed with our monolithic ICs, which combine a high-voltage transistor with low-voltage control circuitry, or with a number of competing alternatives. These alternatives include other monolithic and hybrid ICs, pulse width modulation (PWM) controller ICs paired with discrete transistors, and legacy technologies that do not utilize ICs, such as line-frequency transformers and self-oscillating switchers using discrete components.

Our sales process involves significant effort to convince our customers to design their power supplies using our ICs as components. Competition for these design wins at our customers is intense, as the power-supply industry is extremely price-sensitive. We attempt to differentiate our offerings from competing alternatives through innovation aimed at helping our customers minimize the total cost of their power supplies while meeting the performance specifications demanded by their end customers. Much of this innovation is embodied in the features and functionality of our ICs, as well as in various power-supply design techniques developed by us for use by our customers. Further, we attempt to minimize the cost of producing our ICs through continuous improvement of our proprietary manufacturing process as well as seeking other manufacturing efficiencies.

We employ a variety of methods for marketing and selling our products in an effort to accelerate the penetration of our addressable markets. We employ a staff of sales personnel and field applications engineers around the world, and have increased the size of this staff considerably over the past several years. In order to assist our customers in designing power supplies with our ICs, we offer a wide range of technical documentation as well as design-support tools and services. These include our PI Expert design software, which we offer free of charge, and our transformer sample service. We also continue to introduce more advanced products that make our solutions more cost-effective and easier for designers to use.

We believe that the increasing importance of energy-efficiency as a design criterion for power supplies could help accelerate the rate of adoption of our technology by the power-supply industry, and represents an important opportunity for us to increase the penetration rate of our products. This trend is predominantly the result of the emergence of energy-efficiency standards that encourage, or in some cases mandate, the design of more energy-efficient electronic products. Power supplies built with legacy technologies such as line-frequency transformers are often unable to meet such standards cost-effectively. Most notably, the California Energy Commission has introduced mandatory standards governing the energy efficiency of virtually all external power supplies; these standards are scheduled to take effect for all products in July of 2007. Other U.S. states, as well as Australia, have adopted virtually identical mandatory standards scheduled to take effect in 2007 and 2008. Further, in response to concerns about the energy inefficiency of incandescent lighting, various policymakers have enacted or proposed policies that could result in more rapid adoption of alternative lighting technologies such as light-emitting diodes (LEDs). We believe that this trend represents an additional market opportunity for us, since our ICs are used in power-supply circuitry to provide low-voltage DC power for LED light fixtures.



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***Restatement of Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2005***

**Background**

We announced on March 13, 2006 that a Special Committee of our board of directors was conducting an internal investigation of our practices related to stock option grants to officers, directors and employees, and related matters. The Special Committee was comprised of disinterested members of our board of directors and was assisted by independent outside legal counsel and accounting experts.

In a Form 8-K filed on May 9, 2006, we disclosed that the Special Committee had reached a preliminary conclusion that the actual dates of measurement for certain past stock option grants differed from the recorded grant dates for such awards, and that, accordingly, we expected to record additional material non-cash charges for stock-based compensation expenses in prior periods. On the same Form 8-K, we announced that we may need to restate our historical financial statements for each of the fiscal years 1999 through 2004, and for the first three quarters of the fiscal year ended December 31, 2005, and that the Audit Committee of the Board of Directors had concluded that the financial statements for these prior periods and any related reports of its independent registered public accounting firm should no longer be relied upon. In early May 2006, we accepted the resignations of Howard Earhart, our Chairman of the Board and former Chief Executive Officer, and of John Cobb, our Chief Financial Officer.

On May 24, 2006, the Special Committee advised our board of directors of its final conclusion that, among other things, the recorded grant dates for certain option grants should not be relied upon. After receiving the Special Committee's conclusions and consistent with those conclusions, we reviewed stock option grants during the period from 1998 through June 2006. The restated condensed consolidated financial statements for the three and nine months ended September 30, 2005, contained in this Form 10-Q reflect corrections resulting from those reviews.

We have incurred substantial expenses related to our special investigation and subsequent internal investigation, which began in early 2006. In addition, we are the subject of several derivative actions filed against certain of our current and former directors and officers as well as investigations launched by the U.S. Attorney's Office for the Northern District of California and the staff of the Securities and Exchange Commission regarding our past stock option granting practices, as more fully described in Part II, Item I, Legal Proceedings. We have incurred approximately \$13.7 million in costs for legal fees, external audit firm fees, and external consulting fees and board of director meeting fees in the twelve months ended December 31, 2006, and expect to incur additional fees related to the special investigation and financial statement restatements until we are current with all delinquent filings.

In addition to the stock-based compensation expenses, and the related income and payroll tax effects, we recorded adjustments to correct other errors that occurred in the periods ended December 31, 2001 through the third quarter of 2005.

**Restatement Adjustments**

Our restated condensed consolidated financial statements for the three and nine months ended September 30, 2005 contained in this Form 10-Q incorporate adjustments related to stock-based compensation expense, payroll tax expense and other accounting adjustments, including the income tax effect related to the restatement adjustments. Each of these items is described below. The restatement adjustments resulted in a reduction of our previously reported consolidated net income for the three and nine months ended September 30, 2005 of approximately \$0.4 million and \$1.1 million, respectively. The restatement reduced earnings per diluted share for the three and nine months ended September 30, 2005, by \$0.01 and \$0.04, respectively.

The table below presents the effect of the individual restatement adjustments for the three and nine months ended September 30, 2005, which are explained in further detail following the table (in thousands):

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|   | Three Months<br>Ended September 30,<br>2005 | Nine Months<br>Ended September 30,<br>2005 |
|---|---|--|
| <b>STOCK COMPENSATION:</b>  |   |  |
| New hire non-officer stock option grants accounted for as being made prior to the terms being fixed | \$ 49                                       | \$ 154                                     |
| Stock option grants with insufficient or incomplete corporate approvals                             | 475   | 1,704                                      |
| Stock option grants cancelled and repriced  | 32  | 389  |
| Accelerated vesting and other matters related to stock-based compensation                           | (2)   | 27   |
| Total stock compensation expense  | 554   | 2,274                                      |
| Payroll taxes, interest and penalties   | 28  | (226)                                      |
| Total stock compensation related adjustments  | 582   | 2,048                                      |
| <b>OTHER MISCELLANEOUS ACCOUNTING ADJUSTMENTS:</b>  |   |  |
| Correction of sales returns reserve   |   | 520  |
| Correction of period of charge for cost of wafers used in engineering                               |   | (108)                                      |
| Correction of expected life of tooling for depreciation purposes                                    | (64)  | (64)                                       |
| Total other miscellaneous accounting adjustments  | (64)  | 348  |
| Total adjustments to decrease income before income tax  | 518   | 2,396                                      |
| <b>INCOME TAX BENEFIT</b>   | <b>123</b>                                  | <b>1,301</b>                               |
| Total adjustments to decrease net income  | \$ 395                                      | \$ 1,095                                   |
| <b>DECREASE IN EARNINGS PER DILUTED SHARE</b>   | <b>\$ 0.01</b>                              | <b>\$ 0.04</b>                             |

*Stock-Based Compensation* These adjustments are from our determination, based upon the Special Committee's investigation and our subsequent reviews and analyses, that the initially recorded measurement dates for various categories of stock option grants could not be relied upon. These categories included the following:

*New-hire non-officer stock option grants accounted for as being made prior to the terms being fixed.* Our practice was to set the exercise price of new-hire non-officer awards based upon the fair value of our stock on the employee's hire date or the last day of the month of the employee's first month of employment, whichever was lower. Because this determination was made at the end of the month of hire, the last day of the month of the employee's first month of employment was determined to be the first date when the number of shares and the price of each grant were known with finality. Grants accounted for as being made before the last day of the month of the employee's first month of employment, which represented options to purchase an aggregate of 1,168,383 shares, as of September 30, 2005, were accounted for as fixed awards under Accounting Principles Board Opinion (APB) No. 25 Accounting for Stock Issued to Employees, or APB 25.

*Stock option grants with insufficient or incomplete corporate approvals.* We determined that for certain stock option grants the number of shares and the exercise price were not known with finality at the original measurement date. We determined that the original recorded grant date could not be relied on because there was correspondence or other evidence that indicated that not all required corporate approvals had been obtained, including the finalization of the number of stock options allocated and the related exercise price. We adopted a methodology to remeasure these option grants to a revised measurement date, as described below, and accounted for these grants, which represented options to purchase an aggregate of 6,350,639 shares, as of September 30, 2005, as fixed awards under APB 25.

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*Stock option grants determined to have been cancelled and repriced.* We determined that the terms of certain stock option grants to purchase an aggregate of 415,000 shares, as of September 30, 2005, may have been communicated to employees and that those terms were subsequently modified. We concluded that such modifications constituted repricings and, therefore, that these stock option grants should have been accounted for as variable awards for accounting purposes.

*Accelerated vesting and other matters related to stock-based compensation.* Accelerated vesting consists primarily of the acceleration of stock option vesting, with respect to options to purchase an aggregate of 341,174 shares, upon termination of a few employees prior to 2001, which resulted in stock-based compensation expense which had not been previously recorded. The other matters relate primarily to the impact of the capitalization in inventory of stock-based compensation through September 30, 2005.

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*Payroll taxes, interest and penalties* In connection with the stock-based compensation adjustments, we determined that certain options previously classified as Incentive Stock Option, or ISO, grants were determined to have been granted with an exercise price below the fair market value of our stock on the revised measurement date (see discussion under Accounting Considerations below). Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant, and therefore these grants might not qualify for ISO tax treatment. We refer to these stock options as the Affected ISOs. The potential disqualification of ISO status exposes us to additional payroll related withholding taxes on the exercise of these Affected ISOs granted to U.S. employees, and penalties and interest for failing to properly withhold taxes on exercise of those options. The payroll tax, interest and penalty expenses were recorded in the periods in which the underlying stock options were exercised. Then, in subsequent periods in which the liabilities were legally extinguished due to statutes of limitations, the expenses were reversed, and recognized as a reduction in the related functional expense category in our consolidated statements of income. The net tax liability at September 30, 2006 for this potential disqualification of ISO tax treatment for option awards totaled \$0.7 million.

Management is considering possible ways to address the impact that Section 409A of the Internal Revenue Code may have as a result of the exercise price of stock options being less than the fair market value of our common stock on the revised measurement date. Section 409A imposes significant additional taxes to our employees on stock options granted with an exercise price lower than the fair market value on the date of grant that vest after December 31, 2004. The Internal Revenue Service has issued transition rules under Section 409A that allows for a correction, or cure, for options subject to Section 409A. We have allowed our current and former executive officers to amend their options to effect such a cure. We may offer the other holders of outstanding options the opportunity to effect a cure of all affected stock options. In connection with this cure, we may make cash bonus payments in an aggregate amount of up to \$1.0 million in 2008 to non-officer employees.

*Other miscellaneous accounting adjustments* In addition to stock-based compensation expenses, we recorded adjustments that had not been previously reflected in the Company's condensed consolidated financial statements. These adjustments relate primarily to a correction of our sales return reserve, which should have been reduced in 2001. In addition, we also corrected the period of expense for certain wafers used in engineering and corrected the expected life of tooling for depreciation purposes.

Further, we corrected the classification on the balance of callable securities between short-term investments and long-term investments, included as a component of total assets, as of September 30, 2005. We also corrected the consolidated statements of cash flows for the effects of the aforementioned restatements as well as to correct for the non-cash effects of property and equipment purchases recorded, but not yet paid for, at each period end.

*Income tax benefit* We reviewed the income tax effect of the stock-based compensation charges, and we believe that the proper income tax accounting for U.S. stock options under generally accepted accounting principles depends, in part, on the tax distinction of the stock options as either ISOs or non-qualified stock options, or NSOs. Although some of the Affected ISOs were originally intended to be ISOs, we noted that, under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant. Because of the potential impact of the measurement date changes on the qualified status of Affected ISOs, we have determined that all Affected ISOs might not be qualified ISOs under the regulations, and therefore should be accounted for as if they were NSOs for income tax accounting purposes.

We have recorded a net income tax benefit of approximately \$13.5 million in connection with the stock-based compensation related expense and other restatement adjustments during the period from fiscal year 1998 to September 30, 2005. This income tax benefit has resulted in an increase to our deferred tax assets for all U.S. affected stock options prior to the exercise or forfeiture of the related options. We recorded no income tax benefit or deferred tax asset for affected stock options granted to non-U.S. employees because we determined that we could not receive tax benefits outside of the U.S. Further, we limited the deferred tax assets recorded for affected stock options granted to certain highly paid officers to reflect estimated limitations on tax deductibility under Internal Revenue Code Section 162(m). Upon exercise or forfeiture of the underlying options, the excess or deficiency in deferred tax assets are written-off to either expense or paid-in capital in the period of exercise or forfeiture.

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Our board of directors has ratified each of the options granted, and we intend to honor each stock option granted pursuant to the terms of the applicable stock option plan and stock option agreement.

### **Accounting Considerations Stock-Based Compensation**

We originally accounted for all employee, officer and director stock option grants as fixed grants under APB 25, using a measurement date of the recorded grant date. We issued all grants with an exercise price equal to the fair market value of our common stock on the recorded grant date, and therefore originally recorded no stock-based compensation expense.

As a result of the Special Committee findings, and our own further review of our stock option granting practices, we determined that the measurement dates for certain stock option grants differed from the recorded grant dates for such grants. In some instances, we were only able to locate sufficient evidence to identify the measurement date described in APB 25, the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known, within a range of possible dates. As a result, we developed a methodology to establish the revised measurement date primarily by using communication dates as our estimate of the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known with finality. Using the methodology described below we concluded that it was appropriate to revise the measurement dates for these grants based upon our findings, and we refer to these revised measurement dates as the *Deemed Measurement Dates*. We calculated stock-based compensation expense under APB 25 based upon the intrinsic value as of the *Deemed Measurement Dates* of stock option awards determined to be *fixed* under APB 25 and the vesting provisions of the underlying options. We calculated the intrinsic value on the *Deemed Measurement Date* as the closing price of our common stock on such date as reported on the Nasdaq National Market, now the Nasdaq Global Market, less the exercise price per share of common stock as stated in the underlying stock option agreement, multiplied by the number of shares subject to such stock option award. We recognize these amounts as compensation expense over the vesting period of the underlying options (generally four years). We also determined that variable accounting treatment was appropriate under APB 25 for certain stock option grants to three officers for which evidence was obtained that the terms of the options may have been communicated to those officers and that those terms were subsequently modified (stock option grants cancelled and repriced). When variable accounting is applied to stock option grants, we remeasure, and report in our consolidated statement of income, the intrinsic value of the options at the end of each reporting period until the options are exercised, cancelled or expire unexercised.

The methodology we used to determine the *Deemed Measurement Dates* associated with prior stock option grants was as follows:

*New-Hire Non-Officer Employee Stock Options* We determined the *Deemed Measurement Date* for each of these grants to be the last day of the month of the employee's first month of employment. Our practice was to set the exercise price of these awards at the end of the month of hire, and therefore we determined that the last day of the month of the employee's first month of employment was the first date when the number of shares and the price of each grant were known with finality.

*All Other Stock Options* We determined the *Deemed Measurement Date* for each stock option grant, other than grants of new hire non-officer employee options, to be the Approval Date for the stock option, provided the Approval Date criteria set forth below were met. If the criteria for use of the Approval Date were not met, then we used the Communication Date, as defined below, as the *Deemed Measurement Date* for the stock option.

*Approval Date* The Approval Date was the date of approval set forth in executed minutes or a fully-executed consent of the board of directors, compensation committee or stock option committee documenting the grant of the stock option. However, we generally only used the Approval Date as the *Deemed Measurement Date* if both:

- (1) there was documentary evidence that the allocation of the shares had been finalized, and the written consent, if applicable, was executed, on that date ; and
- (2) the Communication Date for the stock option was within 30 days of the date of approval set forth in the documentary evidence.

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**Communication Date** We define the **Communication Date** as the date we determined the key terms of the option (both the number of shares and the exercise price) had initially been communicated to the optionee. In the absence of specific documentary evidence of initial communication, we generally determined the **Communication Date** to be the earliest of:

- (1) the date the employee record of the grant of the stock option was added to the stock option database application, or the latest recordation date in the case of a group of grants, which we refer to as the **Record Add Date** ;

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- (2) the optionee manual signature date on the stock option agreement, or the earliest optionee manual signature date in the case of a group of grants, which we refer to as the Stock Option Agreement Date ; and
  
- (3) for officers and directors, the date that a Form 3 or 4 was filed with the SEC with respect to the grant, which we refer to as the Form 3/4 Date .

However, we did not consider the Record Add Date in our determination if the Stock Option Agreement Date was more than 30 days after the Record Add Date in the case of individual grants and grants to groups of less than five, or more than 10 days after the Record Add Date in the case of grants to groups of five or more. We made the distinction regarding small and large groups because we would expect to see at least one agreement returned to us within 10 days with larger groups of optionees; but with small groups, the probability of seeing an agreement returned to us within 10 days was less likely.

When applying this methodology to groups of grants, we generally determined the Communication Date for the group to be the latest Record Add Date, the earliest Stock Option Agreement Date or Form 3/4 Dates, as we determined that, under our stock option grant process, the terms of stock options were communicated concurrently to each member of a group. We excluded a limited number of options, or Outliers , from the determination of the latest Record Add Date and the earliest Stock Option Agreement Date for a group of grants when, based upon available evidence, we considered the Outlier dates as not reliable as to the date that the terms of the stock option grants were communicated to the group. This methodology, and the determination of which stock option grants should be considered Outliers, as described above, involves judgment.

**Outside Director Automatic Stock Option Grants**

Our 1997 Outside Directors Stock Option Plan provides for the automatic grant of stock options to our outside directors, such that the grants require no independent action of the Board or any committee of the Board. The Outside Directors Plan provides that each outside director is granted a stock option to purchase 30,000 shares of Power Integrations, Inc. common stock upon appointment as a member of the Board, and that each outside director is granted a stock option to purchase 10,000 shares of our common stock at each anniversary of the date of appointment or, in the case of outside directors appointed prior to our initial public offering, the anniversary date of the initial public offering. The exercise price of each stock option grant is the fair market value of a share of common stock on the date of grant.

We have determined that, as a result of administrative errors, a total of 16 grants representing options to purchase 180,000 shares under the Outside Directors Plan collectively to three of our outside directors were documented as having been made on dates other than as set forth in the Outside Directors Plan. We have corrected the documentation of these grants to reflect the correct dates and exercise prices, as automatically established under the Outside Directors Plan. Because these actions were corrections of administrative errors in the documentation, rather than changing any of the terms of the stock option grants as automatically granted, we determined that there was no accounting charge to be recognized in connection with these corrections, as the correct measurement date was the date of grant as automatically established by the Outside Directors Plan, and the exercise price was the fair market value of our common stock on the correct measurement date.

**Related Proceedings**

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of Power Integrations, against certain of Power Integrations' current and former executives and members of our board of directors relating to our historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in

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the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco's counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. The consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of Power Integrations' shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. On July 20, 2007, the parties entered a stipulation by which the plaintiffs would file an amended complaint on or before August 1, 2007. Pursuant to the stipulation, Power Integrations' response to the amended complaint will be due on September 10, 2007.

On May 26, 2006, Stanley Banko, an alleged shareholder, filed a derivative complaint in the Superior Court of California, Santa Clara County, purportedly on behalf of Power Integrations, against certain of our current and former executives and members of Power Integrations' board of directors relating to our historical stock option granting practices. On May 30, 2006, Joan Campbell, also an alleged shareholder, filed a derivative suit in the Superior Court of California, Santa Clara County, making the identical allegations asserted in the Banko lawsuit. On June 30, 2006, pursuant to a stipulation by the parties, the Court consolidated the two cases into a single proceeding and required plaintiffs to file an amended, consolidated complaint. Plaintiffs filed their consolidated complaint on August 14, 2006, in which plaintiffs named additional officers and former officers and KPMG LLP, Power Integrations' former auditor, as new defendants. The consolidated complaint alleges, among other things, that the defendants caused or allowed Power Integrations' executives to manipulate their stock option grant dates, that defendants improperly backdated stock option grants, and that costs associated with the stock option grants were not properly recorded in Power Integrations' financial statements. The complaint asserts claims for, among other things, insider trading, breach of fiduciary duty, gross mismanagement and unjust enrichment. On September 15, 2006, the Court stayed this action until January 19, 2007. The parties have filed a stipulation to extend the stay until October 5, 2007.

On May 23, 2006, the U.S. Attorney's Office for the Northern District of California, or DOJ, issued a grand jury subpoena to us directing that we produce documents relating to the granting of stock options from 1995 through the present. On May 31, 2006, the staff of the Securities and Exchange Commission, or SEC, sent a letter to us directing us to take appropriate actions to preserve certain documents relating to our stock option practices. Since that time, the government has made a number of requests for us to voluntarily produce documents relating to, among other things, our stock option practices. In addition, the government has been conducting voluntary interviews of certain current and former officers and employees. We are cooperating fully with the SEC and the DOJ and intend to continue to do so.

We are unable to predict the outcome of the legal proceedings described above. If an adverse decision is reached against us in any of these proceedings, it could have a material adverse effect on our financial position or results of operations.

### *Effect on our Nasdaq Listing*

Our common stock has been suspended from trading on The NASDAQ Stock Market for noncompliance with the Nasdaq listing requirements, and currently trades on the Pink Sheets under the symbol POWI.PK. Until we file all of our delinquent SEC filings, we will not be in compliance with the Nasdaq listing requirements. Even when we do regain compliance with the Nasdaq listing requirements, we will be required to reapply to have our common stock listed on the Nasdaq Global Market, and there is no assurance that our application will be successful.

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

Our critical accounting policies are as follows:

revenue recognition;

stock-based compensation;

estimating sales returns and allowances;



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estimating distributor pricing credits;

estimating allowance for doubtful accounts;

estimating write-downs for excess and obsolete inventory; and

income taxes.

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We believe that these policies and estimates are important to the portrayal of our financial condition and results 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.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 related to revenue recognition, sales returns, allowance for distributor pricing credits, allowance for doubtful accounts, write downs for excess and obsolete inventory, stock-based compensation and income taxes. 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.

### **Revenue recognition**

Product revenues consist of sales to OEMs, merchant power supply manufacturers and distributors. Shipping terms to our international OEMs and merchant power supply manufacturers from our facility in California are delivered at frontier , which is commonly referred to as DAF. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of our product in that country. Beginning in December 2005, shipping terms to our international OEMs and merchant power supply manufacturers shipped 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 North American OEMs and merchant power supply manufacturers are FOB-point of origin meaning that revenue is recognized upon shipment, when the title is passed to the customer.

We make sales to distributors under terms allowing certain rights of return and protection against subsequent price declines 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 customers. We determine the amount to defer based on the level of actual inventory on hand at our distributors as well as inventory that is in transit to our 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.

### **Stock-based compensation**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment* (SFAS 123R) which requires the measurement and recognition of compensation expense for share-based payment awards. We estimate the fair value of employee stock options and employee stock purchase rights under our Employee Stock Purchase Plan ( ESPP Shares ) on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model requires us to estimate the expected terms of awards, expected stock price volatility, dividend rate, and the risk-free interest rate. These estimates, some of which are highly subjective, greatly affect the fair value of each employee stock option and ESPP share. We calculate our estimate of expected volatility for both stock options and ESPP shares using a weighted average of our historical stock price volatility and the implied volatility of our shares. We monitor the assumptions used to compute the fair value of our stock-based awards, and we will revise our assumptions as appropriate. In the event that we later determine that assumptions used to compute the fair value of our stock-based awards need to change significantly in future periods, stock-based compensation expense and, therefore, our results of operations, could be materially impacted.

Prior to the adoption of SFAS 123R, we recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations. APB No. 25 provided that compensation expense relative to our employee stock options were measured based on the intrinsic value of stock options granted. For grants determined to be fixed under APB 25, we recognize compensation expense in our statement of income using the straight-line method over the vesting period based upon the difference between the exercise price of our employee stock option grants and the market price of the underlying common stock on the measurement date of the option. We did not recognize compensation expense in our consolidated income statement for fixed awards when the exercise price of our employee stock option grants equaled the market price of the underlying common stock on the measurement date of the option. The measurement date was the date when the number of shares and exercise price were known with finality. For grants determined to be variable under APB 25, we remeasured, and reported in our statement of income, the intrinsic value of the options at the end of each reporting period until the

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options were exercised, cancelled or expired unexercised. We had a restatement of our consolidated financial statements, as described in Restatement of Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2005 above. In accordance with SFAS 123R, as of January 1, 2006, previously recorded deferred compensation of \$746,000 has been eliminated with a corresponding reduction in additional paid in capital.

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

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

### **Estimating distributor pricing credits**

Historically, approximately 55% to 65% of our total sales have been made to distributors. Frequently, our distributors need a cost lower than our standard distribution price in order to win business. In these circumstances, the distributor submits a request to us for a lower sell-in price on a specific end-customer transaction or a series of transactions. After the distributor ships product to its customer under an approved transaction, the distributor submits a ship and debit claim to us 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 approved lower price. We maintain a reserve for these credits that appears as a reduction to accounts receivable in our accompanying condensed consolidated balance sheet. Any increase in the reserve results in a corresponding reduction in our net revenues. To establish the adequacy of our reserves, we analyze historical ship and debit amounts and levels of inventory in the distributor channels. If our reserves are not adequate, our net revenues could be adversely affected.

From time to time we will reduce our distribution list prices. When this occurs, we give our distributors credits, referred to as price protection, on products they hold in their inventories. Since we do not recognize revenue until the distributor sells the product to its customers, we generally do not need to provide reserves for price protection. However, in rare instances we must consider price protection in the analysis of reserve requirements, as there may be a timing gap between a price decline and the issuance of price protection credits. If a price protection reserve is required, we will maintain a reserve for these credits that appears as a reduction to accounts receivable in our accompanying condensed consolidated balance sheet. Any increase in the reserve results in a corresponding reduction in our net revenues. We analyze distribution price declines and levels of inventory in the distributor channels. If our reserves are not adequate, our net revenues could be adversely affected.

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

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

### **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.



**Table of Contents****Income taxes**

We recognize federal, state and foreign current tax liabilities or assets based on our estimate of taxes payable or refundable in the current fiscal year by tax authorities. We also recognize federal, state and foreign deferred tax liabilities or assets for our estimate of future tax effects attributable to temporary differences and carry-forwards, and we record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized. We limit the deferred tax assets recognized related to certain of our highly-paid officers to amounts that we estimate will be deductible in future periods based upon the provisions of the Internal Revenue Code Section 162(m). As of September 30, 2006, we had recorded no valuation allowance to reduce our deferred tax assets. We believe it is more likely than not that forecasted income will be sufficient to fully recover our deferred tax assets. In the event that we determine all or part of the net deferred tax assets not to be realizable in the future, we would record a valuation allowance in the period in which such determination is made, which could adversely affect our operating results. 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.

**Results of Operations**

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

|  | Percentage of<br>Total Net Revenues for<br>Three Months Ended<br>September 30, |                     | Percentage of<br>Total Net Revenues for<br>Nine Months Ended<br>September 30, |                     |
|--|--|---------------------|---|---------------------|
|  | 2006   | 2005<br>As restated | 2006  | 2005<br>As restated |
| Net revenues                             | 100.0%   | 100.0%              | 100.0%  | 100.0%              |
| Cost of revenues                         | 45.8   | 50.6                | 45.1  | 51.3                |
| Gross profit.                            | 54.2   | 49.4                | 54.9  | 48.7                |
| Operating expenses:                      |  |                     |   |                     |
| Research and development                 | 14.3   | 11.7                | 15.0  | 12.1                |
| Sales and marketing                      | 14.3   | 12.5                | 15.7  | 12.6                |
| General and administrative               | 23.0   | 11.6                | 22.1  | 10.0                |
| Total operating expenses                 | 51.6   | 35.8                | 52.8  | 34.7                |
| Income from operations                   | 2.6  | 13.6                | 2.1   | 14.0                |
| Total other income                       | 3.6  | 2.5                 | 3.6   | 2.2                 |
| Income before provision for income taxes | 6.2  | 16.1                | 5.7   | 16.2                |
| Provision (benefit) for income taxes     | 0.2  | 1.7                 | 0.4   | 2.6                 |
| Net income                               | 6.0%   | 14.4%               | 5.3%  | 13.6%               |

**Comparison of the Three Months and Nine Months Ended September 30, 2006 and 2005**

*Net revenues.* Net revenues for the three months ended September 30, 2006 were \$44.4 million compared to \$36.5 million for the three months ended September 30, 2005, an increase of \$7.9 million, or 21.6%. The increase was driven by increased penetration of our products across all of our major end markets, particularly the consumer and industrial end markets. Growth in sales into the consumer end market was driven by higher sales for applications such as appliances, consumer audio products and external power supplies. Growth in sales to the industrial end market was driven by higher sales for applications such as industrial controls, external chargers and lighting applications. In addition, the increase in net revenues was driven by higher sales of our TinySwitch-II and III products as well as our LinkSwitch products, partially offset by

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lower sales of legacy products such as TOPSwitch-I and TinySwitch-I.

Net revenues for the nine months ended September 30, 2006 were \$121.1 million compared to \$105.2 million for the comparable period of 2005, an increase of \$15.9 million or 15.1%. The increase in our net revenues was driven primarily by increased penetration of our products in the industrial and consumer end markets. As stated above, growth into the consumer end market was driven by higher sales for applications such as appliances, consumer audio products and external power supplies, and growth in sales to the industrial end market was driven by higher sales for applications such

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as industrial controls, external chargers and lighting applications. In addition, the increase in our revenues for the nine months ended September 30, 2006, included a benefit of \$3.4 million, or 2.8%, from the recovery of prior-period ship-and-debit claims with one of our distributors. This recovery was partially offset by approximately \$0.7 million in ship-and-debit credits processed for another distributor, which were outside of our standard ship and debit policy.

Revenue mix by product family for the three and nine months ended September 30, 2006 compared to the three and nine months ended September 30, 2005, was as follows:

|                               | Three Months<br>Ended | Three Months<br>Ended | Nine Months<br>Ended | Nine Months<br>Ended |
|-------------------------------|-----------------------|-----------------------|----------------------|----------------------|
| Product Family                | Sept 30,<br>2006      | Sept 30,<br>2005      | Sept 30,<br>2006     | Sept 30,<br>2005     |
| TinySwitch-I, -II and -III    | 54%                   | 53%                   | 52%                  | 55%                  |
| TopSwitch-FX, -GX, -I and -II | 36%                   | 41%                   | 37%                  | 40%                  |
| LinkSwitch                    | 9%                    | 5%                    | 9%                   | 4%                   |
| DPA-Switch                    | 1%                    | 1%                    | 2%                   | 1%                   |

Approximate revenue mix by end markets served for the three and nine months ended September 30, 2006 compared to the three and nine months ended September 30, 2005 was as follows:

|               | Three Months<br>Ended | Three Months<br>Ended | Nine Months<br>Ended | Nine Months<br>Ended |
|---------------|-----------------------|-----------------------|----------------------|----------------------|
| End Market    | Sept 30,<br>2006      | Sept 30,<br>2005      | Sept 30,<br>2006     | Sept 30,<br>2005     |
| Consumer      | 31%                   | 31%                   | 32%                  | 31%                  |
| Communication | 25%                   | 28%                   | 27%                  | 29%                  |
| Computer      | 22%                   | 23%                   | 19%                  | 23%                  |
| Industrial    | 15%                   | 11%                   | 15%                  | 10%                  |
| Other         | 7%                    | 7%                    | 7%                   | 7%                   |

International sales were \$41.2 million in the third quarter of 2006 compared to \$34.0 million for the same period in 2005, an increase of \$7.2 million, or 21%. International sales represented 92.8% of net revenues compared to 93.0% in the three months ended September 30, 2006 and 2005, respectively. International sales were \$111.8 million for the nine months ended September 30, 2006 compared to \$98.7 million for the same period in 2005, an increase of \$13.1 million, or 13.3%. International sales represented 92.3% of net revenues compared to 93.8% in the nine months ended September 30, 2006 and 2005, respectively.

Although the power supplies using our products are distributed to end markets worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region were 77.2% and 77.1% of our sales for the three months ended September 30, 2006 and 2005, respectively, and 77.1% and 78.3% of our sales for the nine months ended September 30, 2006 and 2005, respectively. We expect international sales, and sales to Asian customers in particular, to continue to account for a large portion of our net revenues.

Net product sales for the third quarter of 2006 were divided 62.2% to distributors and 37.8% to OEMs and power supply merchants, compared to 61.3% to distributors and 38.7% to OEMs and power supply merchants for the third quarter of 2005. For the nine months ended September 30, 2006, net product sales were divided 63.3% to distributors and 36.7% to OEMs and power supply merchants, compared to 60.0% to distributors and 40.0% to OEMs and power supply merchants for the same period in 2005. In the three months ended September 30, 2006, one customer, a distributor, accounted for approximately 25.5% of our net revenues. In the three months ended September 30, 2005, the same distributor and one other distributor accounted for approximately 19.3% and 18.1% of our net revenues, respectively. No other customers accounted for 10% or more of our net revenues in that period. For the nine months ended September 30, 2006, sales to one distributor accounted for approximately 21.2% of our net revenues, the same distributor and one other distributor accounted for approximately 19.6% and 17.5% of our net revenues, respectively, for the nine months ended September 30, 2005. No other customers accounted for 10% or more of our net revenues in those periods.

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*Cost of revenues; Gross profit.* Gross profit is equal to net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our foundries MEI, OKI Electric Industry Co., Ltd., or OKI, and ZMD Analog Mixed Signal Services GmbH & Co. KG, or ZFOUNDRY, a wholly-owned subsidiary of X-FAB Semiconductor Foundries AG (as of March 2007), as well as the assembly and packaging of our products by sub-



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contractors, internal labor and overhead costs associated with the testing of both wafers and packaged components, and testing of packaged components by sub-contractors. Gross profit was \$24.0 million, or 54.2% of net revenues, for the three months ended September 30, 2006, compared to \$18.1 million, or 49.4% of net revenues, for the three months ended September 30, 2005. Gross profit for the nine months ended September 30, 2006 was \$66.5 million, or 54.9% of net revenues, compared to \$51.2 million, or 48.7% of net revenues for the same period in 2005.

The increase in our gross profit margin for the three and nine months ended September 30, 2006 was driven primarily by reductions in product costs, caused partly by the increased use of overseas subcontractors for the testing of our ICs. In addition, the increase in our gross profit margin for the nine months ended September 30, 2006, was partially due to the above-mentioned ship-and-debit recovery and claims with two of our distributors, which increased our revenue and gross profit by \$2.7 million. These increases were partially offset by higher stock-based compensation expenses, reflecting the implementation of SFAS 123R. Stock-based compensation expenses included in cost of revenues totaled \$0.4 million and \$0.9 million for the three and nine months ended September 30, 2006, respectively, and \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2005, respectively, as recorded under APB 25.

*Research and development expenses.* Research and development expenses consist primarily of employee-related expenses (including stock-based compensation), expensed engineering material and facility costs associated with the development of new processes and new products. We also expense prototype wafers and mask sets related to new products as research and development costs until new products are released to production. Research and development expenses for the third quarter of 2006 were \$6.3 million, or 14.3% of net revenues, compared to \$4.3 million or 11.7% of net revenues in the same period in 2005. Research and development expenses for the nine months ended September 30, 2006 were \$18.2 million, or 15.0% of net revenues, compared to \$12.8 million or 12.1% of net revenues in the same period a year prior. The increase in both the three and nine month periods was driven primarily by higher stock-based compensation expenses reflecting the implementation of SFAS 123R in the first quarter of 2006. Stock-based compensation expenses totaled \$1.0 million and \$3.3 million for the three and nine months ended September 30, 2006, compared to \$0.2 million and \$0.7 million in the same periods in 2005. In addition, we incurred increased payroll and related expenses for the three and nine months ended September 30, 2006 when compared to the same periods in 2005, primarily as a result of increased headcount. Research and development expenses also increased in the three and nine months ended September 30, 2006 by approximately \$0.4 million, as a result of the cancellation of a previously capitalized software project, and the subsequent write-off of capitalized project costs. We expect research and development expenses to increase in absolute dollars in future periods, but these expenses may fluctuate as a percentage of our net revenues.

*Sales and marketing expenses.* Sales and marketing expenses consist primarily of employee-related expenses (including stock-based compensation), commissions to sales representatives, facilities expenses including expenses associated with our regional sales offices and support offices, and field application engineering costs. Sales and marketing expenses were \$6.3 million, or 14.3% of net revenues, for the third quarter of 2006, compared to \$4.6 million, or 12.5% of net revenues for the same period in 2005. Sales and marketing expenses for the nine months ended September 30, 2006 were \$19.1 million, or 15.7% of net revenues, compared to \$13.2 million, or 12.6% of net revenues for the same period in 2005. The increase in sales and marketing expenses was due primarily to higher stock-based compensation expenses reflecting the implementation of SFAS 123R, which began in the first quarter of 2006. Stock-based compensation expenses totaled \$1.3 million and \$4.3 million for the three and nine months ended September 30, 2006, compared to \$0.2 million and \$0.5 million in the same periods in 2005. In addition, we incurred increased payroll and related expenses for the three and nine months ended September 30, 2006 compared to the same periods in 2005, primarily as a result of increased headcount. We expect sales and marketing expenses to continue to increase in absolute dollars in future periods, but these expenses may fluctuate as a percentage of our net revenues.

*General and administrative expenses.* General and administrative expenses consist primarily of employee-related expenses (including stock-based compensation) for administration, finance, human resources and general management, as well as consulting fees, outside services, legal fees and fees for audit and tax services. For the quarter ended September 30, 2006, general and administrative expenses were \$10.2 million, or 23.0% of net revenues, compared to \$4.2 million, or 11.6% of net revenues, in the same period in 2005. For the nine months ended September 30, 2006, general and administrative expenses were \$26.7 million, or 22.1% of net revenues, compared to \$10.5 million, or 10.0% of net revenues, in the same period in 2005. The increases for both the three and nine month periods were driven primarily by higher professional fees associated with an internal investigation of our practices for granting and accounting for stock options, and the related restatement of our financial statements, as described in note 3 in our notes to condensed consolidated financial statements. These expenses totaled \$4.7 million and \$10.7 million for the three and nine month periods ended September 30, 2006. The increases were also driven by higher stock-based compensation expenses, which totaled \$1.0 million and \$3.3 million for the three and nine months ended September 30, 2006 compared to \$0.2 million

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and \$0.7 million for the same periods in 2005. Expenses related to patent litigation also contributed to the increases in the nine months ended September 30, 2006; these expenses totaled \$5.5 million, compared to \$3.1 million for the same period in 2005. We expect our general and administrative expenses to remain throughout 2006 at a significantly higher percentage of our net revenues than has historically been the case.

*Other income, net.* Other income, net, for the third quarter of 2006 was \$1.6 million compared to \$0.9 million for the same period in 2005. For the nine months ended September 30, 2006, other income, net, was \$4.4 million compared to \$2.4 million for the same period in 2005. Other income consists primarily of interest income earned on short-term and long-term investments. The increase in other income is attributed to higher interest rates year-over-year.

*Provision (benefit) for income taxes.* Provision for income taxes represents federal, state and foreign taxes. The provision for income taxes was \$0.1 million for the quarter ended September 30, 2006, compared to \$0.6 million for the quarter ended September 30, 2005. The provision for income taxes was \$0.5 million for the nine months ended September 30, 2006 compared to \$2.7 million for the same period in 2005. Our estimated effective tax rate for the three and nine months ended September 30, 2006 was approximately 4% and 8%, respectively. The difference between the expected statutory rate of 35% and our effective tax rates for the three and nine months ended September 30, 2006 was due primarily to international sales which are subject to lower tax rates, lower taxable income recorded in higher tax rate jurisdictions caused by increased expenses incurred in connection with our previously announced investigation into our historical stock option practices and the resulting restatements of our prior financial statements, and the favorable effects of research and development tax credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees. The difference between the expected federal statutory rate of 35% and the Company's effective tax rates for the three and nine month periods ended September 30, 2005, was primarily due to the beneficial impact of international sales subject to lower tax rates and research and development credits. Our estimate of our annual effective income tax rate for 2006 may change in the future.

## **Liquidity and Capital Resources**

As of September 30, 2006, we had \$128.4 million in cash, cash equivalents and short-term and long-term investments, a decrease of approximately \$2.1 million from December 31, 2005. In addition, under a revolving line of credit with Union Bank of California, which expired on October 1, 2006, we could borrow up to \$10.0 million. We used a portion of the credit line to cover advances for commercial letters of credit and standby letters of credit, which we provide to MEI prior to the shipment of wafers to us, and also to our workers compensation insurance carrier as part of our insurance program. As of September 30, 2006, there were outstanding letters of credit totaling approximately \$1.2 million. The balance of this credit line was unused and available as of September 30, 2006. On October 26, 2006, we entered into a security agreement with Union Bank of California, whereby we agreed to maintain \$1.3 million in an interest bearing certificate of deposit with the bank. The purpose of this agreement is to secure commercial letters of credit and standby letters of credit up to the deposit amount. This agreement remains in effect until cancellation of our letters of credit.

As of September 30, 2006, we had working capital, defined as current assets less current liabilities, of approximately \$127.5 million, a decrease of approximately \$5.3 million from December 31, 2005. The decrease in working capital was the result of an increase in accounts payable due primarily to the timing of payments to our wafer foundries, an increase in accrued liabilities due to the timing of service fee payments related to our special investigation, restatement and patent litigation, and an increase in deferred income on sales to distributors as a result of higher distributor inventory. The decrease was partially offset by an increase in inventory, consistent with an expected increase in our revenues, as well as an increase in prepaid expenses, due primarily to prepayments to one of our foundries, in order to secure raw materials.

Our operating activities generated cash of \$22.7 million and \$22.3 million in the nine months ended September 30, 2006 and 2005, respectively, an increase of approximately \$0.4 million. The increase in cash flow from operations was the result of various offsetting factors, explained as follows: in the first nine months of 2006, adjustments to reconcile our net income of \$6.4 million to cash flows from operating activities consisted primarily of depreciation and amortization of \$5.2 million and stock-based compensation expense of \$11.8 million. In the first nine months of 2006, cash flows resulting from changes in operating assets and liabilities consisted primarily of an increase in accounts payable of approximately \$4.9 million, due primarily to the timing of payments to our wafer foundries, an increase in taxes payable and accrued liabilities of \$5.8 million due to the timing of service fee payments related to our special investigation and restatement, and an increase of \$1.9 million in deferred income on sales to distributors as a result of higher distributor inventory. This increase was partially offset by an increase in our inventory of \$8.6 million, consistent with an increase in our sales, an increase in prepaid expenses of \$2.9 million due primarily to prepayments to one of our foundries in order to secure raw materials, and an increase in accounts receivable of \$1.6 million as a result of higher revenue in the third

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quarter of 2006 compared to the fourth quarter of 2005. Cash generated in the first nine months of 2005 was principally the result of net income in the amount of \$14.4 million, depreciation and amortization of \$4.7 million, and a decrease in inventory of \$3.2 million, and stock-based compensation expense of \$2.3 million, partially offset by an increase in accounts receivable of \$2.4 million and a decrease in accounts payable of \$1.9 million.

Our investing activities in the nine months ended September 30, 2006 consisted of a \$17.2 million net use of cash. Our investing activities consisted of net purchases of \$6.2 million of held-to-maturity investments, purchases of property and equipment of \$7.9 million, and the acquisition of a technology license from our foundry OKI, for \$3.0 million, to be utilized in the production of our products. The acquired license from OKI, and other licenses and patent rights are reported net of accumulated amortization on the Company's condensed consolidated balance sheet. We amortize the cost of intangible assets (licenses and patents) over the term of the acquired license or patent rights, which ranges from five to twelve years. Our investing activities for the nine months ended September 30, 2005 consisted of a \$9.2 million net use of cash, which was driven primarily by the issuance of a \$10.0 million promissory note to a supplier, purchases of property and equipment totaling \$2.6 million and the acquisition of technology for \$1.1 million. These uses of cash were offset in part by net proceeds of \$4.5 million from short-term and long-term investments.

Our financing activities for the nine months ended September 30, 2006 consisted primarily of the use of \$19.6 million of cash, including fees, for the repurchase of approximately 1.1 million shares of our common stock, and net proceeds of \$5.6 million from the issuance of common stock through the exercise of stock options and purchases through our employee stock purchase plan. Our financing activities for the nine months ended September 30, 2005 included the use of \$28.3 million for the repurchase of approximately 1.4 million shares of our common stock, offset by net proceeds from the issuance of common stock through the exercise of stock options and purchases through our employee stock purchase plan of \$7.0 million.

On October 19, 2005, we announced that our board of directors had authorized the repurchase of up to \$25 million of our common stock. From inception of the stock repurchase program in October 2005 through June 30, 2006, we had repurchased 1.3 million shares for approximately \$25 million, the total amount authorized by the Company's board of directors. There were no shares repurchased in the quarter ended September 30, 2006.

There has not been a material change in our contractual commitments from those described in our 2005 Annual Report on Form 10-K.

During the first nine months of 2006, a significant portion of our cash flow was generated by our operations. If our operating results were to deteriorate as a result of a decrease in customer demand for our products, or severe pricing pressures from our customers or our competitors, or for other reasons, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, or seek financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

### **Recent Accounting Pronouncements**

Updates to recent accounting standards as disclosed in our Form 10-K for the year ended December 31, 2005 are as follows:

In February 2007, the Financial Accounting Standards Board, or FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, we may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an instrument-by-instrument basis, even if we have similar instruments that we elect not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by us in the first quarter of 2008. We currently are determining whether fair value accounting is appropriate for any of our eligible items and cannot estimate the impact, if any, that SFAS 159 will have on our consolidated results of operations and financial condition.



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

There has not been a material change in our exposure to interest rate and foreign currency risks from that described in our 2005 Annual Report on Form 10-K.

*Interest Rate Risk.* Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. We do not use derivative financial instruments in our investment portfolio to manage our interest rate risk, foreign currency risk, or for any other purpose. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we 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 ensure portfolio liquidity. We do not hold any instruments for trading purposes. At September 30, 2006 and December 31, 2005, we held primarily cash equivalents and short-term investments, with maturity dates of less than twelve months, and 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. Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts; however, the contract prices to purchase wafers from MEI and OKI are denominated in Japanese yen and both agreements 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 subject our gross profit and operating results to the potential for material fluctuations. We maintain a Japanese yen account with a U.S. bank for payments to our wafer suppliers in Japan.

**ITEM 4. CONTROLS AND PROCEDURES.**

**Limitations Regarding the Effectiveness of Control Systems**

It should be noted that any control system, no matter how well designed and operated, can provide only reasonable assurance 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.

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 ( Exchange Act ), as of the end of the period covered by this report, September 30, 2006. Disclosure controls and procedures under the Exchange Act mean the controls and other procedures that are designed to provide reasonable assurance that the information required to be disclosed by Power Integrations in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to provide reasonable assurance that information required to be disclosed by Power Integrations in the reports that it files or submits under the Exchange Act is accumulated and communicated to Power Integrations' management, including its chief executive officer and chief financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2006, our disclosure controls and procedures were not effective as a result of three material weaknesses that existed in our internal control over financial reporting and because on that date, we expected to miss the timely filing of this Quarterly Report on Form 10-Q. The three material weaknesses, which are described in more detail in the following section, are related to accounting for stock option grants, income tax accounting and the application of generally accepted accounting principles material to non-routine transactions.

### **Internal Control Over Financial Reporting**

#### *Management's Quarterly Report on Internal Control over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the Exchange Act, internal control over financial reporting means a process designed by, or under the supervision of, the principal executive and principal financial officers, or persons performing similar functions, and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of Power Integrations' assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and, (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our chief executive officer and chief financial officer concluded that our internal control over financial reporting was not effective as of September 30, 2006. Three material weaknesses, as described in the following paragraphs, existed in our internal control over financial reporting, and therefore our internal control over financial reporting was not operating effectively as of September 30, 2006. A material weakness is defined as a significant deficiency, or combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

#### **Control Activities Related to Accounting for Stock Option Grants**

As of September 30, 2006, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of SFAS No. 123(R), which replaced APB 25 effective January 1, 2006.

In the course of our investigation of our stock option granting practices, which we conducted in 2006, we determined that our controls were not adequate to ensure that our stock option grants had a correctly recorded grant date, the first date on which the number of shares that an individual employee was entitled to receive and the exercise price were both known with finality. This included not having sufficient controls in place to ensure that option grants received the required corporate approvals. Moreover, we did not have sufficient controls in place to properly account for stock option grants that had modifications in key terms.

This lack of internal controls and procedures led to incorrect application of APB 25 for periods prior to January 1, 2006, which provided that compensation expense relative to our employee stock options should be measured based on the intrinsic value of stock options granted. For periods after December 31, 2005, this lack of internal controls and procedures led to incorrect application of SFAS No. 123(R), which provides for share-based compensation expense based on fair value, as further described in Note 3 of the financial statements. Based on our investigation, we concluded that original measurement dates on certain stock option grants could not be relied upon for accounting purposes and that the appropriate charges for such stock option grants and for stock option grants where key terms were potentially modified had not been properly recorded. As a result we did not correctly account for stock-based compensation expense for certain stock option grants.

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In connection with errors that resulted from this material weakness, we recorded non-cash charges for stock-based compensation and the related payroll and income tax effects in prior periods, and, we restated our historical consolidated financial statements in our December 31, 2005 Form 10-K for each of the fiscal years ended 1998 through 2004, and each of the first three quarters of the year ended December 31, 2005, and for each of the four quarters of the year ended December 31, 2004.

Additionally, subsequent to the filing of our Annual Report on Form 10-K for the year ended December 31, 2004, we determined that we erroneously applied certain aspects of SFAS No. 123. As a result, we had to make certain changes in the assumptions we used to calculate pro forma net income, and the footnote disclosures under the provisions of SFAS No. 123. Accordingly, we determined that our controls were not adequate to ensure that the assumptions we used were accurate.

As of September 30, 2006, these material weaknesses had not been remediated. Therefore, we did not have sufficient controls in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of APB 25 and SFAS No. 123(R), which replaced APB 25 in 2006.

### **Control Activities Relating to Income Tax Accounting**

As of September 30, 2006, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the accounting and review of our income taxes payable, deferred income tax assets and liabilities, and the related tax provision.

In connection with the preparation of our 2006 consolidated financial statements, we determined that we did not have appropriate staffing resources to perform our tax accounting functions. Specifically, there was a failure to consistently apply generally accepted accounting principles in determining our income taxes payable, deferred income tax assets and liabilities, and the related tax provision. In the course of reviewing these errors, we determined that our controls were not adequate to ensure the completeness and accuracy of the tax provision in accordance with generally accepted accounting principles.

### **Control Activities Relating to the Application of Generally Accepted Accounting Principles to Material, Non-Routine Transactions**

As of September 30, 2006, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of generally accepted accounting principles to material, non-routine, non-systematic transactions.

This third material weakness resulted from an adjustment of \$1.4 million of legal expenses we paid and assumed would be reimbursed under our D&O insurance policy. We originally recorded a receivable for this amount. After subsequent review, we determined that this was a gain contingency, as per SFAS No. 5, *Accounting for Contingencies*, specifically paragraph 179(a), and should not be recorded as a receivable at December 31, 2006 because to do so might be a recognition of a gain prior to its realization. Consequently we failed to appropriately apply generally accepted accounting principles to the accounting for this transaction and concluded that there was more than a remote likelihood that a material misstatement of our annual financial statements would not have been prevented or detected.

### ***Changes in Internal Control over Financial Reporting***

There has been no change in our internal control over financial reporting during the quarter ended September 30, 2006, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. However, subsequent to the date on this Form 10-Q the following changes have occurred:

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### **Changes Related to Stock Options**

Subsequent to the date of this Form 10-Q, in response to the identification of the material weakness described above, we have taken the following corrective actions:

Improvements in disclosure controls and internal control over financial reporting

- i We held internal training sessions with our executives, finance, and human resources personnel to roll out the revised stock option granting policy and increase competency levels related to stock option granting.

Improvements in our stock option granting process and related controls to ensure our stock option grants have a correctly recorded grant date, the first day on which the number of shares and exercise price are known with finality

- i Our compensation committee refined and limited delegation of authority to a subcommittee to grant stock options, and eliminated the use of written consents by the compensation committee for the purpose of granting options to help avoid issues regarding timing of receipt of written consents.
- i We now require that all evergreen, new hire, promotional and retention stock options be granted either (i) by our stock option committee on a predetermined schedule, (ii) by our board of directors or (iii) at a meeting of our compensation committee.
- i In addition, all stock option grants to the executive staff must be made by the board of directors or our compensation committee.
- i We worked with our attorneys and board of directors to review and update our stock option granting policy, which included requirements for the timing of the authorization, pricing and vesting of stock option grants. In addition, we worked with a cross functional team including finance, human resources, and our external legal counsel to implement controls related to the revised stock option granting policy. This included the timing of the authorization, pricing and vesting of stock option grants.

### **Changes Related to Tax Accounting**

Subsequent to the date of this Form 10-Q, in response to the identification of the material weakness related to tax accounting, we have initiated the following corrective actions:

To strengthen our processes related to tax accounting, management improved our review process by adding additional reviews, and, with the assistance of our third party tax accounting firm, engaged, and seeks to further engage, more senior and qualified tax personnel. These changes were made after the end of our fiscal year 2006.

Although management has made changes to strengthen this area of tax accounting, management has not had an opportunity to test whether this material weakness has been remedied.

### **Changes Related to the Application of Generally Accepted Accounting Principles to Material Non-Routine Transactions**

Subsequent to the date of this Form 10-Q, in response to the identification of the material weakness related to the application of generally accepted accounting principles to material non-routine transactions, we have initiated the following corrective actions:

To strengthen our processes relating to the accounting for material, non-routine, non-systematic transactions in accordance with generally accepted accounting principles, subsequent to the end of our fiscal year 2006, we have implemented a process to identify and research those items and engage technical expertise, if determined to be required, to provide reasonable assurance that the transactions are prepared in



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accordance with generally accepted accounting principles. Our policy requires the contemporaneous documentation and evaluation of complex and unusual transactions, which are material either by the size or the nature of the transaction. In conjunction with this policy, we are implementing more rigorous controls for ensuring that those transactions which involve a significant level of management judgment or which by the nature of the transactions rise a level requiring communication to the Audit Committee are, in fact, communicated to the Audit Committee on a timely basis.

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Management is in the process of remediating these material weaknesses, and has taken steps to help ensure that all individuals involved in administering the relevant processes are now aware of the revised controls. Although these design changes have been implemented, management has not had the opportunity to evaluate the operating effectiveness of these revised controls.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On June 28, 2004, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (System General), a Taiwanese company, and its U.S. subsidiary. Our complaint alleges that certain integrated circuits produced by System General infringed and continue to infringe certain of our patents. We seek, among other things, an order enjoining System General from infringing our patents and an award for damages resulting from the alleged infringement. On June 10, 2005, in response to the initiation of the U.S. International Trade Commission (ITC) investigation (discussed below), the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay. On December 6, 2006, System General filed a notice of appeal of the ITC decision as discussed below. In response, and by agreement of the parties, the District Court renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination.

On May 9, 2005, we filed a Complaint with the ITC under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337. We filed a supplement to the complaint on May 24, 2005. We alleged infringement of certain of our patents pertaining to pulse width modulation (PWM) integrated circuit devices. The Commission instituted an investigation on June 8, 2005 in response to our complaint. Systems General Corporation filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. We subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (ALJ) from January 18 to January 24, 2006. 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. 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 Systems General PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing Systems General chip. The U.S. Customs Service is authorized to enforce the exclusion order which is now in full effect. On December 6, 2006 System General filed a notice of appeal of the ITC decision. Briefing has been completed, and the appeal will be heard by the U.S. Court of Appeals for the Federal Circuit in the coming months.

On October 20, 2004, we filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In our complaint, we alleged that Fairchild has and is infringing four 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 us. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of us finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding \$33,981,781 in damages. Although the jury awarded damages, and we will request the damages to be enhanced in view of the jury's finding on willfulness, at this stage of the proceedings we cannot state the amount, if any, which might ultimately be recovered by us from Fairchild, and no benefits have been recorded in our consolidated financial statements as a result of the damages award. Fairchild has raised defenses contending that the asserted patents are invalid or unenforceable, and the court set a second trial on these issues to begin on September 17, 2007.

On April 11, 2006, Fairchild Semiconductor Corporation and Intersil Corporation filed a patent infringement lawsuit against us the U.S. District Court for the Eastern District of Texas. The complaint asserts that we infringed on an old Intersil patent that Fairchild recently secured exclusive rights to assert against us but Fairchild and Intersil did not identify any specific products they believe infringe the patent. Fairchild and Intersil's lawsuit is flawed because both Fairchild and Intersil lack standing to sue us and it is also duplicative of a portion of our suit against Fairchild in Delaware, and we therefore filed a motion addressing both issues. The Texas Court granted us motion to transfer the case to Delaware on March 6, 2007, and the case has been transferred to Delaware and assigned to Judge Farnan, the presiding

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judge in the Fairchild case discussed above. The Delaware Court has scheduled a status conference for August 2, 2007, but there have been no further developments in the case. We continue to believe Fairchild's case should be dismissed for lack of standing, or in the alternative, be stayed pending the outcome of the trial against Fairchild later this year. In either case, we do not expect Fairchild's suit to have any impact on our lawsuit against Fairchild.

On June 14, 2007, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. subsidiary. Our complaint alleges that certain integrated circuits produced by BCD infringe certain of our patents. We seek, among other things, an order enjoining BCD from infringing our patents and an award for damages resulting from the alleged infringement. BCD has not yet answered the complaint.

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of Power Integrations, against certain of Power Integrations' current and former executives and members of our board of directors relating to our historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco's counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. The consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of Power Integrations' shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. On July 20, 2007, the parties entered a stipulation by which the plaintiffs would file an amended complaint on or before August 1, 2007. Pursuant to the stipulation, Power Integrations' response to the amended complaint will be due on September 10, 2007.

On May 26, 2006, Stanley Banko, an alleged shareholder, filed a derivative complaint in the Superior Court of California, Santa Clara County, purportedly on behalf of Power Integrations, against certain of our current and former executives and members of Power Integrations' board of directors relating to our historical stock option granting practices. On May 30, 2006, Joan Campbell, also an alleged shareholder, filed a derivative suit in the Superior Court of California, Santa Clara County, making the identical allegations asserted in the Banko lawsuit. On June 30, 2006, pursuant to a stipulation by the parties, the Court consolidated the two cases into a single proceeding and required plaintiffs to file an amended, consolidated complaint. Plaintiffs filed their consolidated complaint on August 14, 2006, in which plaintiffs named additional officers and former officers and KPMG LLP, Power Integrations' former auditor, as new defendants. The consolidated complaint alleges, among other things, that the defendants caused or allowed Power Integrations' executives to manipulate their stock option grant dates, that defendants improperly backdated stock option grants, and that costs associated with the stock option grants were not properly recorded in Power Integrations' financial statements. The complaint asserts claims for, among other things, insider trading, breach of fiduciary duty, gross mismanagement and unjust enrichment. On September 15, 2006, the Court stayed this action until January 19, 2007. The parties have filed a stipulation to extend the stay until October 5, 2007.

On May 23, 2006, the U.S. Attorney's Office for the Northern District of California, or DOJ, issued a grand jury subpoena to us directing that we produce documents relating to the granting of stock options from 1995 through the present. On May 31, 2006, the staff of the Securities and Exchange Commission, or SEC, sent a letter to us directing us to take appropriate actions to preserve certain documents relating to our stock option practices. Since that time, the government has made a number of requests for us to voluntarily produce documents relating to, among other things, our stock option practices. In addition, the government has been conducting voluntary interviews of certain current and former officers and employees. We are cooperating fully with the SEC and the DOJ and intend to continue to do so.

The Internal Revenue Service, or IRS, is conducting an audit of our 2002 and 2003 tax returns. The IRS has issued a number of Notices of Proposed Adjustment to these returns. Among other things, the IRS has challenged several aspects of our research and development cost-sharing arrangement, which was put into place on November 1, 2003. While we have agreed to some of the adjustments proposed by the IRS, we dispute other proposed adjustments.

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

### 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.*

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

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

the volume and timing of orders received from customers;

competitive pressures on selling prices;

the demand for our products declining in the major end markets we serve;

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

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

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

SEC and U.S. Department of Justice investigations and stockholder litigation related to our previous internal investigation of our practices related to stock option grants and the related restatement of our consolidated financial statements;

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 litigation against Fairchild Semiconductor, System General Corporation, and BCD;

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

the licensing of our intellectual property to one of our wafer foundries;

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the lengthy timing of our sales cycle;

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

reliance on international sales activities for a substantial portion of our net revenues;

our ability to develop and bring to market new products and technologies on a timely basis;

the ability of our products to penetrate additional markets;

attraction and retention of qualified personnel in a competitive market;

changes in environmental laws and regulations; and

earthquakes, terrorists acts or other disasters.

*We do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and our business may suffer.* Our business is characterized by short-term customer orders and shipment schedules. Our customer base is highly concentrated, and a relatively small number of distributors, OEMs and merchant power supply manufacturers account for a significant portion of our revenues. Our top ten customers, including distributors, accounted for 58%, of our net revenues for the nine months ended September 30, 2006. In April 2006, we terminated our relationship with a distributor that was one of our top two customers in 2005. We have replaced this relationship with other distribution relationships, and do not believe that the termination has had a material impact on our business. The ordering patterns of some of our existing large customers have been unpredictable in the past and we expect that customer-ordering patterns will continue to be unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without significant penalty to the customer. In the past we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time.

*Intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products.* The high-voltage power supply industry is intensely competitive and characterized by significant price sensitivity. Our products face competition from alternative technologies, such as linear transformers, discrete switcher power supplies, and other integrated and hybrid solutions. If the price of competing solutions decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized go outside the cost-effective range of our products, some of these alternative technologies can be used more cost effectively. In addition, as our patents expire, our competitors could legally begin using the technology covered by the expired patents in their products, potentially increasing the performance of their products and/or decreasing the cost of their products, which may enable our competitors to compete more effectively. Our current patents may or may not inhibit our competitors from getting any benefit from an expired patent. One of our patents recently expired, and our remaining U.S. patents have expiration dates ranging from 2009 to 2026. 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



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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.

*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.

*We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient wafers, our business may suffer.* We have supply arrangements for the production of wafers with Matsushita, OKI and ZFoundry. Our contracts with these suppliers expire in June 2010, April 2008, and December 2009 respectively. Although certain aspects of our relationships with Matsushita, OKI and ZFoundry are contractual, many important aspects of these relationships depend on their continued cooperation. We cannot assure that we will continue to work successfully with Matsushita, OKI or ZFoundry 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, Matsushita or ZFoundry could harm our business. We estimate that it would take nine to 18 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. Any of these concessions 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. In addition, our IC assembly process requires our manufacturers to use a high-voltage molding compound that, until recently, has been available from only one supplier. In December 2006, an alternative molding compound, made by a different supplier was qualified for use on our highest volume package type. These compounds and their specified processing conditions require a more exacting level of process control than normally required for standard IC packages. Unavailability of assembly materials or problems with the assembly process can materially adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

In addition, if prices for commodities used in our products increase significantly, raw materials costs of our suppliers would increase and could result in increased product costs our suppliers charge us. If we are not able to pass these costs on to our customers, this would have an adverse effect on our gross margins.

*We are subject to SEC and U.S. Department of Justice investigations and stockholder litigation related to our recent internal investigation of our practices related to stock option grants and the related restatement of our consolidated financial statements.* The SEC and the U.S. Department of Justice, or DOJ, are both conducting



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investigations related to our internal investigation of our practices related to stock option grants. In addition, three alleged shareholders of Power Integrations have filed derivative complaints in the United States District Court for the Northern District of California, and two alleged shareholders have filed derivative complaints in Superior Court of California, Santa Clara County, all purportedly on behalf of Power Integrations, against certain of our current and former executive officers and directors in connection with our option granting practices alleging, among other things, breaches of fiduciary duties and in the federal court cases violations of Section 10(b) of the Securities Exchange Act of 1934. The shareholder derivative suits are discussed in more detail in Part II, Item 1 of this Form 10-Q. The ongoing legal fees we are incurring in connection with these actions, and any fines that we may be required to pay in the event that the SEC or DOJ determine, as a result of their investigations, to bring any civil or other actions against us, or any attorneys' fees that we may be required to pay as a result of the derivative suits, would have an adverse effect on our operating results. Further, these actions require a significant amount of our senior management's attention, which detracts from their ability to manage our company's business.

*Our stock has been delisted from The NASDAQ Stock Market LLC and there is no guarantee that we will be successful in relisting it.* Our common stock has been suspended from trading on The Nasdaq Global Market for noncompliance with the Nasdaq listing requirements, and currently trades on the Pink Sheets under the symbol POWI.PK. Until we are current with our SEC filings, we will not be compliant with the Nasdaq listing requirements. Even when we do regain compliance with the Nasdaq listing requirements, our common stock will not automatically begin trading on Nasdaq again. In order to have our common stock resume trading on the Nasdaq Global Market, we will need to reapply to Nasdaq to have our stock listed. The application process can be lengthy, and there is no assurance that Nasdaq will relist our common stock.

*Recently enacted changes in 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 new rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly qualified members to serve on our audit committee.

Additionally, we cannot be sure that we will be able to successfully remediate the currently reported material weaknesses in our system of internal controls. Our efforts to comply with Section 404 of the Sarbanes-Oxley Act and the related regulations regarding our required assessment of our internal controls over financial reporting and our external auditors' attestation report on our management's assessment of our internal controls continues to require the commitment of significant financial and managerial resources.

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

*If we do not prevail in our litigation against Fairchild Semiconductor, System General, and BCD we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of proprietary rights.* We are in patent litigation with each of Fairchild Semiconductor, System General Corp., and BCD Semiconductor Manufacturing Limited, and the outcome of this litigation is uncertain. The next phase of the Fairchild suit will determine whether or not our patents at issue in the suit are valid. One of the patents that is the subject of the litigation has recently expired. In addition, there is no assurance that we will be successful in obtaining financial damages or an injunction against all System General products or BCD products that infringe our patents. We have incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits. Thus, even if we are successful in these lawsuits, we will have incurred significant legal costs, potentially without any benefit which could have a material adverse effect on our business. Further, if we are not successful in the Fairchild lawsuit, our patents at issue in the suit may be determined invalid and we will not receive any damages, including the \$34 million the jury awarded us in October 2006, nor will we have the intellectual property protection we currently believe is provided by these patents.

*We are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of items, and if we are not successful in defending our position we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future.* Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by the IRS and state, local and foreign tax authorities. In connection with an IRS audit of our United States federal income tax

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returns for fiscal years 2002 and 2003, the IRS is asserting that we owe additional taxes relating to a number of items, the most significant of which is our research and development cost sharing arrangements with one of our subsidiaries. We disagree with the IRS's position; however, if we are not successful in defending our position, we could be required to pay additional taxes, penalties and interest for 2002 and 2003, as well as for subsequent years that are not currently under audit. Resolution of this matter could take considerable time, possibly years.

We believe the IRS's position with respect to certain items for which it has proposed adjustments is inconsistent with applicable tax laws, and that we have meritorious defenses to our position with respect to these proposed adjustments. Accordingly, we intend to continue to challenge the IRS's position on these matters vigorously. While we believe the IRS's asserted position on these matters is not supported by applicable law, we may be required to make additional payments in order to resolve these matters. If the IRS determines that we owe additional taxes for these matters, our results of operations and financial condition would be materially and adversely affected.

*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 Matsushita and OKI are denominated in Japanese yen. The agreements with both 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 subject our gross profit and operating results to the potential for material fluctuations.

*Matsushita has licenses to our technology, which it may use to our detriment.* Pursuant to a Technology Agreement with Matsushita, which expired in June 2005, Matsushita has the perpetual right to manufacture and sell products that incorporate our technology to Japanese companies worldwide and to subsidiaries of Japanese companies located in Asia. Matsushita does not have rights to utilize technology developed by us after June 2005, when the agreement expired. According to the expired Technology Agreement, we will continue to receive royalties on Matsushita's sales through June 2009 at a reduced rate. Royalty revenue was less than 1% of total net revenues for the nine months ended September 30, 2006 and less than 2% of total net revenues for the year ended December 31, 2005. However, these royalties are substantially lower than the gross profit we receive on direct sales, and we cannot assure that Matsushita will not use the technology rights to continue to develop and market competing products.

*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 North America account for, and have accounted for a large portion of our net revenues, including approximately 92% and 93% of our net revenues for the nine months ended September 30, 2006 and for the year ended December 31, 2005, 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 adversely affect our operating results. Furthermore, because substantially all of our foreign sales are denominated in U.S. dollars, increases in the value of the dollar cause the price of our products in foreign markets to rise, making our products more expensive relative to competing products priced in local currencies.

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

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

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

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

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

*In the event of an earthquake, terrorist act or other disaster, our operations may be interrupted and our business would be harmed.* Our principal executive offices and operating facilities situated near San Francisco, California, and most



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of our major suppliers, which are wafer foundries and assembly houses, are located in areas that have been subject to severe earthquakes. Many of our suppliers are also susceptible to other disasters such as tropical storms, typhoons or tsunamis. In the event of a disaster, we or one or more of our major suppliers may be temporarily unable to continue operations and may suffer significant property damage. Any interruption in our ability or that of our major suppliers to continue operations at our facilities could delay the development and shipment of our products.

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

*We have adopted anti-takeover measures which may make it more difficult for a third party to acquire us.* Our board of directors may issue up to 2,925,000 shares of preferred stock and determine the price, rights, preferences and privileges of those preferred shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of shares of preferred stock, while potentially providing flexibility in connection with possible acquisitions and for other corporate purposes, could make it more difficult for a third party to acquire a majority of our outstanding voting stock. We have no present intention to issue shares of preferred stock.

In addition, we have entered into a rights agreement, commonly referred to as a poison pill, to guard against abusive hostile takeover tactics. Further, the anti-takeover provisions of Section 203 of the Delaware General Corporations Law apply to us. Our rights agreement and Section 203 of the Delaware General Corporations Law may discourage, delay or prevent a change in control of Power Integrations.

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

On September 14, 2006, an employee of Power Integrations exercised options to purchase 8,822 shares of Power Integrations common stock for an aggregate exercise price of \$0.68 per share. The exercise of the option was made in reliance on Rule 701 promulgated under the Securities Act of 1933, as amended, as the option was granted prior to the initial public offering of Power Integrations' common stock in reliance on Rule 701.

On October 19, 2005, the Company announced that its board of directors had authorized a second stock repurchase program of up to \$25.0 million of the Company's common stock. The board directed that the repurchases be made pursuant to Rule 10b5-1 of the Exchange Act. For the nine months ended September 30, 2006 the Company purchased approximately 1.1 million shares of its common stock for approximately \$19.6 million. From inception of the Company's second stock repurchase plan, to September 30, 2006, the Company repurchased approximately 1.3 million shares for a total of approximately \$25.0 million, concluding this repurchase program.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

None.

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS

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| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 10.32                 | Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and Alan Bickell.(1)        |
| 10.33                 | Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and Nicholas Brathwaite.(1) |

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|-------|--|
| 10.34 | Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and Scott Brown.(1)                           |
| 10.35 | Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and Alan Bickell.(1)        |
| 10.36 | Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and Nicholas Brathwaite.(1) |
| 10.37 | Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and Scott Brown.(1)         |
| 10.38 | 2006 Bonuses to Executive Officers (2)*  |
| 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**   |

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- (1) Incorporated by reference to the like-described exhibit filed with the Company's Annual Report on Form 10-K, filed with the SEC on March 8, 2007.
- (2) Incorporated by reference to the disclosure set forth in the Company's Current Report on Form 8-K, filed with the SEC on February 9, 2007.

\* Indicates a management contract or compensatory plan or arrangement.

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

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: July 31, 2007

By: /s/ RAFAEL TORRES  
Rafael Torres  
Chief Financial Officer (*Principal Financial and Accounting  
Officer*)

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