

POWER INTEGRATIONS INC
Form 10-K/A
June 15, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K/A

(Amendment No. 1)

(Mark One)

☒ **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2010**

or

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

Commission File Number 0-23441

POWER INTEGRATIONS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of

94-3065014
(I.R.S. Employer

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Incorporation or organization)
5245 Hellyer Avenue, San Jose, California
(Address of principal executive offices)

(408) 414-9200

Identification No.)
95138-1002
(Zip code)

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$.001 Par Value	The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ☐ NO ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ☐ NO ☒

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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

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

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

The aggregate market value of registrant's voting and non-voting common stock held by non affiliates of registrant on June 30, 2010, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$653,415,784, based upon the closing sale price of the common stock as reported on The NASDAQ Global Select Market. Shares of common stock held by each officer, director and holder of 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

Outstanding shares of registrant's common stock, \$0.001 par value, as of February 16, 2011: 28,735,053.

EXPLANATORY NOTE

This Amendment (this Amendment) to the Annual Report on Form 10-K, originally filed with the Securities and Exchange Commission on February 25, 2011 (the Form 10-K) of Power Integrations, Inc. is being filed solely for the purpose of inserting the conformed signatures of Deloitte & Touche LLP in Items 9A and 15. This filing makes no other changes to the financial statements originally filed in the Form 10-K.

In addition, we are also including Exhibits 31.1, 31.2, 32.1 and 32.2 required by the filing of this amendment.

PART II

Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures include components of our internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within our disclosure controls and procedures, they are included in the scope of our periodic controls evaluation. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)) were effective as of the end of the period covered by this report.

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act. Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting.

Management conducted an assessment of Power Integrations' internal control over financial reporting as of December 31, 2010 based on the framework established by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in *Internal Control - Integrated Framework*. Based on this assessment, management concluded that, as of December 31, 2010, our internal control over financial reporting was effective.

The effectiveness of Power Integrations' internal control over financial reporting as of December 31, 2010 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal controls over financial reporting during the fourth quarter of our 2010 fiscal year that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Power Integrations, Inc.

San Jose, California

We have audited the internal control over financial reporting of Power Integrations, Inc. and subsidiaries (the Company) as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's 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.

A company's internal control over financial reporting 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 the assets of the company; (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 receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and consolidated financial statement schedule as of and for the year ended December 31, 2010 of the Company and our report dated February 24, 2011 expressed an unqualified opinion on those consolidated financial statements and consolidated financial statement schedule.

/s/ DELOITTE & TOUCHE LLP

San Jose, CA

February 24, 2011

PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) The following documents are filed as part of this Form:

1. Financial Statements

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	46
<u>Consolidated Balance Sheets</u>	47
<u>Consolidated Statements of Income</u>	48
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2. Financial Statement Schedules

Schedule II: Valuation and Qualifying Accounts.

All other schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

3. Exhibits

See Index to Exhibits at the end of this Report, which is incorporated herein by reference. The Exhibits listed in the accompanying Index to Exhibits are filed as part of this report.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Power Integrations, Inc.

San Jose, California

We have audited the accompanying consolidated balance sheets of Power Integrations, Inc. and subsidiaries (the Company) as of December 31, 2010 and 2009, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. Our audits also included the consolidated financial statement schedule listed in the Index at Item 15 (a) 2. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and consolidated financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Power Integrations, Inc. and subsidiaries at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 24, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

San Jose, California

February 24, 2011

POWER INTEGRATIONS, INC.**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share and par value amounts)

	December 31,	
	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 155,667	\$ 134,974
Short-term investments	27,355	20,567
Accounts receivable, net of allowances of \$275 and \$302 in 2010 and 2009	5,713	21,756
Inventories	62,077	26,248
Deferred tax assets	1,435	1,389
Prepaid expenses and other current assets	9,263	10,941
Total current assets	261,510	215,875
INVESTMENTS	31,760	40,100
PROPERTY AND EQUIPMENT, net	84,470	62,381
INTANGIBLE ASSETS, net	9,795	3,099
GOODWILL	14,826	1,824
DEFERRED TAX ASSETS	13,421	14,590
OTHER ASSETS	17,288	6,698
Total assets	\$ 433,070	\$ 344,567
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 20,291	\$ 16,944
Accrued payroll and related expenses	7,395	6,145
Taxes payable		478
Deferred income on sales to distributors	12,221	9,040
Other accrued liabilities	9,548	3,309
Total current liabilities	49,455	35,916
LONG-TERM INCOME TAXES PAYABLE	29,580	23,859
Total liabilities	79,035	59,775
COMMITMENTS AND CONTINGENCIES (Notes 3, 7 and 9)		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.001 par value		
Authorized 3,000,000 shares		
Outstanding None		
Common stock, \$0.001 par value		
Authorized 140,000,000 shares		
Outstanding 28,375,363 and 27,277,927 shares in 2010 and 2009, respectively	28	27
Additional paid-in capital	175,295	150,021
Accumulated translation adjustment	85	4
Retained earnings	178,627	134,740
Total stockholders' equity	354,035	284,792

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Total liabilities and stockholders' equity	\$ 433,070	\$ 344,567
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See accompanying notes to consolidated financial statements.

POWER INTEGRATIONS, INC.**CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share amounts)

	Year Ended December 31,		
	2010	2009	2008
NET REVENUES	\$ 299,803	\$ 215,701	\$ 201,708
COST OF REVENUES	147,262	107,633	96,678
GROSS PROFIT	152,541	108,068	105,030
OPERATING EXPENSES:			
Research and development	35,886	30,473	36,867
Sales and marketing	31,167	25,018	35,898
General and administrative	25,562	23,967	27,296
Intangible asset impairment			1,958
Total operating expenses	92,615	79,458	102,019
INCOME FROM OPERATIONS	59,926	28,610	3,011
OTHER INCOME (EXPENSE):			
Interest income	2,096	2,175	7,608
Interest expense	(3)	(3)	(9)
Insurance reimbursement			878
Other, net	(214)	(259)	(764)
Total other income	1,879	1,913	7,713
INCOME BEFORE PROVISION FOR INCOME TAXES	61,805	30,523	10,724
PROVISION FOR INCOME TAXES	12,341	7,254	8,921
NET INCOME	\$ 49,464	\$ 23,269	\$ 1,803
EARNINGS PER SHARE:			
Basic	\$ 1.78	\$ 0.86	\$ 0.06
Diluted	\$ 1.67	\$ 0.82	\$ 0.06
SHARES USED IN PER SHARE CALCULATION:			
Basic	27,837	26,920	30,099
Diluted	29,556	28,297	31,755

See accompanying notes to consolidated financial statements.

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Common Stock		Additional	Accumulated	Retained	Total
	Shares	Amount	Paid-In Capital	Translation Adjustment	Earnings	Stockholders Equity
BALANCE AT JANUARY 1, 2008	30,070	\$ 30	\$ 176,282	\$ 85	\$ 113,093	\$ 289,490
Issuance of common stock under employee stock option plan	1,157	1	20,611			20,612
Repurchase of common stock	(3,962)	(4)	(82,354)			(82,358)
Accrued payments to employees for tender offer (Note 6)			(9,048)			(9,048)
Issuance of common stock under employee stock purchase plan	265	1	3,267			3,268
Income tax benefits from employee stock option exercises			2,211			2,211
Section 162(m) adjustment for IRS settlement			(246)			(246)
Stock-based compensation expense related to employee stock options			32,091			32,091
Stock-based compensation expense related to employee stock purchases			2,730			2,730
Payment of dividends to stockholders					(730)	(730)
Translation adjustment				(142)		(142)
Net income					1,803	1,803
BALANCE AT DECEMBER 31, 2008	27,530	28	145,544	(57)	114,166	259,681
Issuance of common stock under employee stock option plan	933		16,723			16,723
Repurchase of common stock	(1,403)	(1)	(28,673)			(28,674)
Issuance of common stock under employee stock purchase plan	218		3,630			3,630
Income tax benefits from employee stock option exercises			1,551			1,551
Stock-based compensation expense related to employee stock options and awards			9,148			9,148
Stock-based compensation expense related to employee stock purchases			2,098			2,098
Payment of dividends to stockholders					(2,695)	(2,695)
Translation adjustment				61		61
Net income					23,269	23,269
BALANCE AT DECEMBER 31, 2009	27,278	27	150,021	4	134,740	284,792
Issuance of common stock under employee stock option and stock award plans	1,270	1	22,861			22,862
Net issuance of performance stock unit awards	95		(769)			(769)
Repurchase of common stock	(396)		(13,960)			(13,960)
Issuance of common stock under employee stock purchase plan	128		3,402			3,402
Income tax benefits from employee stock option exercises			5,615			5,615
Section 162(m) adjustment for IRS settlement			(2,724)			(2,724)
Stock-based compensation expense related to employee stock options and awards			9,726			9,726

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Stock-based compensation expense related to employee							
stock purchases	1,123					1,123	
Payment of dividends to stockholders					(5,577)		(5,577)
Translation adjustment				81			81
Net income					49,464		49,464
BALANCE AT DECEMBER 31, 2010	28,375	\$ 28	\$ 175,295	\$ 85	\$ 178,627	\$ 354,035	

See accompanying notes to consolidated financial statements.

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31,		
	2010	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 49,464	\$ 23,269	\$ 1,803
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	12,341	9,667	8,879
Amortization of intangible assets	674	673	937
Intangible asset impairment loss			1,958
Gain on sale of property, plant and equipment	(330)	(5)	(13)
Stock-based compensation expense	10,721	11,330	34,975
Amortization of premium/(discount) on held to maturity investments	1,765	319	(755)
Deferred income taxes	1,124	658	18
Provision for (reduction in) accounts receivable and other allowances	(27)	(4)	124
Excess tax benefit from stock options exercised	(1,309)	(562)	(972)
Tax benefit associated with employee stock plans	2,891	1,403	2,170
Change in operating assets and liabilities:			
Accounts receivable	16,236	(8,709)	1,055
Inventories	(33,588)	2,136	(8,928)
Prepaid expenses and other assets	(8,515)	(10,110)	(3,672)
Accounts payable	(483)	6,838	(1,436)
Taxes payable and other accrued liabilities	5,828	3,825	486
Deferred income on sales to distributors	3,180	4,243	(428)
Net cash provided by operating activities	59,972	44,971	36,201
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(30,567)	(14,356)	(9,097)
Proceeds from sale of property and equipment	1,415		
Investment in third party	(1,831)		
Note to third parties (Note 11)	(6,750)		
Proceeds from note to supplier		10,000	
Acquisition (Note 10)	(8,598)		
Restricted cash			1,050
Purchases of held-to-maturity investments	(27,224)	(60,461)	(29,172)
Proceeds from sales and maturities of held-to-maturity investments	27,010	6,849	108,373
Net cash provided by (used in) investing activities	(46,545)	(57,968)	71,154
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from issuance of common stock	26,263	20,353	23,880
Repurchase of common stock	(13,960)	(28,673)	(82,358)
Payment for tender offer		(9,048)	
Net issuance of performance stock unit awards	(769)		
Excess tax benefit from stock options exercised	1,309	562	972
Payments of dividends to stockholders	(5,577)	(2,695)	(730)
Net cash provided by (used in) financing activities	7,266	(19,501)	(58,236)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	20,693	(32,498)	49,119
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	134,974	167,472	118,353
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 155,667	\$ 134,974	\$ 167,472
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:			
Accrued payment for employee tender offer	\$	\$	\$ 9,048

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Unpaid property and equipment	\$ 5,369	\$ 785	\$ (37)
Application of prepayment to acquisition (Note 10)	\$ 1,200	\$	\$
Conversion of notes receivable in connection with acquisition (Note 10)	\$ 1,752	\$	\$
Conversion of notes receivable in connection with equity investment (Note 11)	\$ 5,169	\$	\$
Acquisition (Note 10)	\$ 6,955	\$	\$
Settlement of pre-existing arrangement in connection with acquisition	\$ 5,250	\$	\$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid for interest	\$ 3	\$ 397	\$ 9
Cash paid for income taxes, net	\$ 3,018	\$ 150	\$ 5,283

See accompanying notes to consolidated financial statements.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010

1. THE COMPANY:

Power Integrations, Inc., (or the Company), incorporated in California on March 25, 1988 and reincorporated in Delaware in December 1997, designs, develops, manufactures and markets proprietary, high-voltage, analog and mixed-signal integrated circuits for use primarily in AC-DC and DC-DC power conversion in the consumer, communications, computer and industrial electronics markets.

The Company is subject to a number of risks including, among others, the volume and timing of orders received from customers, competitive pressures on selling prices, the demand for its products declining in the major end markets it serves, the audit conducted by the Internal Revenue Service, which is asserting that it owes additional taxes relating to a number of items, the inability to adequately protect or enforce its intellectual property rights, fluctuations in the exchange rate between the U.S. dollar and the Japanese yen, the volume and timing of orders placed with the Company's wafer foundries and assembly subcontractors, the continued impact of recently enacted changes in securities laws and regulations including the Sarbanes-Oxley Act, required expenses incurred in connection with its litigation, the lengthy timing of its sales cycle, undetected defects and failures in meeting the exact specifications required by its products, reliance on its international sales activities which account for a substantial portion of net revenues, its ability to develop and bring to market new products and technologies on a timely basis, the ability of its products to penetrate additional markets, attraction and retention of qualified personnel in a competitive market, exposure to risks associated with acquisitions and strategic investments, changes in environmental laws and regulations, earthquakes, terrorist acts or other disasters.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries after elimination of all intercompany transactions and balances.

Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition and allowances for receivables and inventories. These estimates are based on historical facts and various other factors, which the Company believes to be reasonable at the time the estimates are made. However, as future events unfold and their effects cannot be determined with precision, actual results could differ significantly from management's estimates.

Foreign Currency Translation

The functional currencies of the Company's subsidiaries are the local currencies. Accordingly, all assets and liabilities are translated into U.S. dollars at the current exchange rates as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rate prevailing during the period. Cumulative gains and losses from the translation of the foreign subsidiaries' financial statements have been included in stockholders' equity.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash and Cash Equivalents and Investments

The Company considers cash invested in highly liquid financial instruments with maturities of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of December 31, 2010 and December 31, 2009, the Company's short-term and long-term investments consisted of U.S. government-backed securities, municipal bonds, corporate securities, 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.

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

	Amortized Cost	Gross Unrealized		Estimated Fair Market Value
		Gains	Losses	
Investments due in less than 3 months:				
Commercial paper	\$ 7,135	\$	\$	\$ 7,135
Corporate securities	1,508		(1)	1,507
Total	\$ 8,643	\$	\$ (1)	\$ 8,642
Investments due in 4-12 months:				
Corporate securities	\$ 21,255	\$ 84	\$	\$ 21,339
U.S. government securities	5095	20		5,115
U.S. municipal securities	1,005	3		1,008
Total	\$ 27,355	\$ 107	\$	\$ 27,462
Investments due in more than 12 months:				
Corporate securities	\$ 31,760	\$ 648	\$	\$ 32,408
Total	\$ 31,760	\$ 648	\$	\$ 32,408
Total investment securities	\$ 67,758	\$ 755	\$ (1)	\$ 68,512

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortized cost and estimated fair market value for investments classified as held-to-maturity at December 31, 2009 are as follows (in thousands):

	Amortized Cost	Gross Gains	Unrealized Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	\$ 40,772	\$ 6	\$	\$ 40,778
U.S. government securities	2,008		(1)	2,007
Total	\$ 42,780	\$ 6	\$ (1)	\$ 42,785
Investments due in 4-12 months:				
Commercial paper	\$ 2,848	\$	\$	\$ 2,848
Corporate securities	2,660	8		2,668
U.S. government securities	15,059	14		15,073
Total	\$ 20,567	\$ 22	\$	\$ 20,589
Investments due in more than 12 months:				
Corporate securities	\$ 34,865	\$ 207	\$ (91)	\$ 34,981
U.S. government securities	5,234		(11)	5,223
Total	\$ 40,100	\$ 207	\$ (102)	\$ 40,204
Total investment securities	\$ 103,447	\$ 235	\$ (103)	\$ 103,578

Fair Value of Instruments

The Company measures its financial assets and liabilities in accordance with U.S. GAAP. For financial instruments, including cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued expenses, the carrying amounts approximate fair value due to their short maturities.

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):

	December 31,	
	2010	2009
Raw materials	\$ 20,334	\$ 5,870
Work-in-process	13,171	7,694
Finished goods	28,572	12,684
Total	\$ 62,077	\$ 26,248

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Account Receivable (in thousands)

	December 31,	
	2010	2009
Accounts receivable trade	\$ 30,656	\$ 37,676
Accrued ship and debit	(24,481)	(16,967)
Allowance for doubtful accounts	(275)	(302)
Other	(187)	1,349
Total	\$ 5,713	\$ 21,756

Prepaid Expenses and Other Current Assets (in thousands)

	December 31,	
	2010	2009
Prepaid legal fees	\$ 4,000	\$ 4,000
Prepaid inventory (Note 12)	917	2,858
Prepaid income tax	1,117	1,295
Prepaid maintenance agreements	554	527
Interest receivable	737	693
Other	1,938	1,568
Total	\$ 9,263	\$ 10,941

Property and Equipment

Property and equipment consist of the following (in thousands):

	December 31,	
	2010	2009
Land	\$ 16,754	\$ 16,453
Construction-in-progress	10,902	4,555
Building and improvements	30,962	25,498
Machinery and equipment	86,308	73,273
Office furniture and equipment	22,333	19,595
	167,259	139,374
Accumulated depreciation	(82,789)	(76,993)
Total	\$ 84,470	\$ 62,381

Depreciation and amortization expense of property and equipment for fiscal years ended December 31, 2010 and 2009 was approximately \$12.3 million and \$9.7 million, respectively, and was determined using the straight-line method over the following useful lives:

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Building and improvements	4-40 years or life of lease agreement, if shorter
Machinery and equipment	2-8 years
Office furniture and equipment	4 years

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

Total property and equipment located in the United States at December 31, 2010, 2009 and 2008 was approximately 63%, 66% and 70%, respectively, of total property and equipment. In 2010, China held 10% of total property and equipment. In 2009 and 2008, no foreign country held more than 10% of total property and equipment.

Goodwill

Goodwill of \$14.8 million was recorded on the Company's balance sheet, in connection with its 2010 acquisitions of Qspeed Semiconductor and an early-stage research and development company, and the 2007 acquisition of Potentia Semiconductor Corporation. Goodwill is evaluated in accordance with ASC 350-10, *Goodwill and Other Intangible Assets*, and an impairment analysis is conducted on an annual basis, or sooner if the indicators exist for a potential impairment. See Note 8 below for more information on the Company's goodwill activity.

Other Assets (in thousands)

	December 31,	
	2010	2009
Prepaid royalty (Note 11)	\$ 10,000	\$ 5,250
Investment in third party (Note 11)	7,000	1,200
Other	288	248
Total	\$ 17,288	\$ 6,698

Other Accrued Liabilities (in thousands)

	December 31,	
	2010	2009
Accrued payment for acquisition (Note 10)	\$ 6,955	\$
Accrued professional fees	1,013	2,370
Accrued expense for engineering wafers	502	542
Advances from customers	713	217
Other	365	180
Total	\$ 9,548	\$ 3,309

Employee Benefits Plan

The Company sponsors a 401(k) tax-deferred savings plan for all employees in the United States who meet certain eligibility requirements. Participants may contribute up to the amount allowable as a deduction for federal income tax purposes. The Company is not required to contribute; however, from time-to-time the Company will contribute a certain percentage of employee annual salaries on a discretionary basis, not to exceed an established threshold. The Company provided for a contribution of approximately \$0.7 million in both 2010 and 2009. No employee 401(k) match was provided for in 2008.

Impairment of Long-Lived Assets

In accordance with ASC 360-10, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets, such as property and equipment and intangible assets, are reviewed for impairment whenever

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. In the fourth quarter of 2008 the Company performed an analysis of its intangible assets as there was an indicator that the carrying amount of the assets may not be recoverable; as a result of this analysis the Company concluded that three of its intangible assets were impaired. The Company recorded an impairment charge of \$2.0 million as of December 31, 2008. The impairment is reflected in a separate caption in the consolidated statement of income.

Earnings Per Share

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

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

	Year Ended December 31,		
	2010	2009	2008
Basic earnings per share:			
Net income	\$ 49,464	\$ 23,269	\$ 1,803
Weighted-average common shares	27,837	26,920	30,099
Basic earnings per share	\$ 1.78	\$ 0.86	\$ 0.06
Diluted earnings per share(1):			
Net income	\$ 49,464	\$ 23,269	\$ 1,803
Weighted-average common shares	27,837	26,920	30,099
Effect of dilutive securities:			
Employee stock plans	1,719	1,377	1,656
Diluted weighted-average common shares	29,556	28,297	31,755
Diluted earnings per share	\$ 1.67	\$ 0.82	\$ 0.06

- (1) The Company includes the shares underlying performance-based awards in the calculation of diluted EPS when they become contingently issuable per ASC 260-10 (formerly SFAS No. 128, *Earning per Share*.) and excludes such shares when they are not contingently issuable. The Company has included all performance-based awards as those shares became contingently issuable upon the satisfaction of the annual targets consisting of net revenue and non-GAAP operating earnings.

Options to purchase 159,316 shares, 2,788,913 shares and 3,907,268 shares outstanding in the years ended December 31, 2010, 2009 and 2008, respectively, were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Comprehensive Income

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

	Year Ended December 31,		
	2010	2009	2008
Net income	\$ 49,464	\$ 23,269	\$ 1,803
Other comprehensive income:			
Translation adjustments	81	61	(142)
Total comprehensive income	\$ 49,545	\$ 23,330	\$ 1,661

Segment Reporting

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

Revenue Recognition

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

The Company applies the provisions of Accounting Standard Codification (ASC) 605-10 (ASC 605-10) (Formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the customer. The Company considers the price to be fixed based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary.

The Company makes sales to distributors and retail partners and recognizes revenue based on a sell-through method. Sales to distributors are made under terms allowing certain rights of return on the Company's products held by the distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell the Company's products to their

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

customers. The Company determines the amounts to defer based on the level of actual inventory on hand at the distributors as well as inventory in transit to the distributors. The gross profit that is deferred as a result of this policy is reflected as deferred income on sales to distributors in the accompanying consolidated balance sheets. The total deferred revenue as of December 31, 2010 and December 31, 2009 was approximately \$24.7 million and \$17.6 million, respectively. The total deferred cost as of December 31, 2010 and December 31, 2009 was approximately \$12.5 million and \$8.6 million, respectively. In addition, the Company determined the impact of the returns and pricing uncertainties related to the deferred revenue to be negligible over the reported periods.

Approximately 67% of the Company's net product sales were made to distributors in 2010. Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. After the distributor ships product to its customer, the distributor submits a ship and debit claim to the Company to adjust its cost from the standard price to the pre-approved lower price. After verification by the Company, a credit memo is issued to the distributor to adjust the sell-in price from the standard distribution price to the approved lower price. The Company maintains a reserve for these credits that appears as a reduction to accounts receivable in the Company's accompanying consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in the Company's current and/or future net revenues. To establish the adequacy of its reserves, the Company analyzes historical ship and debit payments and levels of inventory in the distributor channels.

For the years ended December 31, 2010, 2009 and 2008, the Company's top ten customers, including distributors that resell the Company's products to OEMs and merchant power supply manufacturers, accounted for approximately 62%, 62% and 60% of net revenues, respectively. Two distributors, Avnet and ATM Electronic Corporation, accounted for approximately 17% and 11% in 2010 and 15% and 10% in 2009, of the Company's net revenues, respectively. For 2008 Avnet accounted for approximately 16% of the Company's net revenues. No other customers accounted for more than 10% of net revenues during these years.

Export Sales

The Company markets its products in and outside of North and South America through its sales personnel and a worldwide network of independent sales representatives and distributors. As a percentage of total net revenues, export sales, which consist of domestic and foreign sales to distributors and direct customers outside of North and South America. Geographic revenue information is based on the customers' bill-to location. The revenue percentages are comprised of the following:

	December 31,		
	2010	2009	2008
Hong Kong/China	33%	26%	35%
Taiwan	23	30	23
Korea	20	22	16
Europe (excluding Germany)	8	8	10
Japan	6	4	5
Germany	2	2	4
Singapore	2	2	2
Other	1	1	1
Total export sales	95%	95%	96%

The remainder of the Company's sales are to customers within North and South America, primarily located in the United States, with some sales to customers located in Mexico and Brazil.

POWER INTEGRATIONS, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Product Sales*

Between 99% and 98% of the Company's sales in the years ended December 31, 2010, 2009 and 2008 were from its three primary groupings of AC-DC power-conversion products TOPSwitch, TinySwitch and LinkSwitch. Each of these product groupings addresses a different segment of the AC-DC power-supply market, differentiated primarily by the output wattage of the power supply. The remaining sales came from other product families, principally the Company's DPA-Switch family of high-voltage DC-DC products.

Revenue mix by product family was as follows:

Product Family	Year Ended December 31,		
	2010	2009	2008
TinySwitch	38%	43%	44%
LinkSwitch	37%	33%	29%
TOPSwitch	24%	23%	25%
Other	1%	1%	2%

Revenue mix by end markets served is comprised of the following:

End Market	Year Ended December 31,		
	2010	2009	2008(1)
Consumer	38%	35%	33%
Communications	31%	34%	34%
Industrial electronics	19%	17%	17%
Computer	12%	14%	16%

- (1) Prior to 2009, the Company's revenue mix by end market included a category called "other," primarily representing revenues from low-volume designs for which the end market was not readily identifiable. Beginning in 2009, the Company eliminated the "other" category, electing instead to allocate these revenues to the four primary end markets using management's estimate of the approximate end-market distribution for these revenues. The Company believes this method provides a more accurate view of its revenue mix by end market. For the sake of comparability with the prior period, the Company revised its revenue mix data for 2008 to reflect the new format, as shown above. For the year ended December 31, 2008 approximately 6% of the Company's total net revenues were reclassified from "other" to the Company's four primary end-market categories. Also, beginning in 2009, the Company reclassified revenues related to certain smart-phone devices from the computer end market category to the communications category; the revenue mix data provided above for 2008 has also been revised to reflect this reclassification. For the year ended December 31, 2008, approximately 5% of the Company's net revenues were reclassified from computer revenues to communications revenues.

Foreign Currency Risk

The Company does not currently employ a foreign currency hedge program utilizing foreign currency forward exchange contracts. The Company maintains a Japanese yen bank account with a U.S. bank for payments to suppliers and for cash receipts from Japanese suppliers and customers denominated in yen. For the years ended December 31, 2010, 2009 and 2008, the Company realized foreign exchange transaction losses of approximately \$415,000, \$305,000 and \$216,000, respectively. These amounts are included in "other income (expense)" in the accompanying consolidated statements of income.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Warranty

The Company generally warrants that its products will substantially conform to the published specifications for 12 months from the date of shipment. The Company's liability is limited to either a credit equal to the purchase price or replacement of the defective part. Returns under warranty have historically been immaterial, and as a result, the Company does not record a specific warranty reserve.

Advertising

Advertising costs are expensed as incurred. Advertising costs amounted to \$1.0 million, \$0.4 million, and \$0.5 million, in 2010, 2009 and 2008, respectively.

Research and Development

Research and development costs are expensed as incurred.

Income Taxes

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

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

As of December 31, 2010, the Company continued to maintain a valuation allowance on a portion of its California deferred tax assets primarily due to California budget legislation as the Company believes that it is not more likely than not that the deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

Common Stock and Common Stock Dividends

In October 2008, the Company's board of directors authorized the use of \$50 million to repurchase the Company's common stock. This repurchase program concluded in the first quarter of 2009, and resulted in the repurchase of approximately 2.7 million shares.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In May 2009, the Company's board of directors authorized the use of an additional \$25 million to repurchase the Company's common stock. From May 2009 to December 31, 2009 the Company purchased 0.5 million shares for approximately \$11.0 million, and in the first two quarters of 2010 the company purchased 0.4 million shares for approximately \$14.0 million, concluding this repurchase program.

In February 2011, the Company's board of directors authorized the use of an additional \$50 million for the repurchase of the Company's common stock. Repurchases will be executed according to certain pre-defined price/volume guidelines set by the board of directors. While the program does not provide for repurchases at current stock price levels, the Company found it prudent to have a program in place. This program commenced in February 2011, and there is no expiration date for this program.

On October 21, 2008, the Company's board of directors declared five quarterly cash dividends of \$0.025 cents per share, to be paid to holders of record as of the dividend record date. The Company began paying dividends on a quarterly basis in the fourth quarter of 2008, and continued through the end of 2009. The last of these quarterly dividend payments was paid in December 2009 to shareholders of record as of November 30, 2009.

In January 2010, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2010. The quarterly dividend payments were made on March 31, 2010, June 30, 2010, September 30, 2010 and December 31, 2010, to stockholders of record as of February 26, 2010, May 28, 2010, August 31, 2010 and November 30, 2010, each in the aggregate amount of approximately \$1.4 million. In October 2010, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2011. The Company expects these quarterly dividends will result in a similar use of cash. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the Company's stockholders.

Stock-Based Compensation

The Company applies the provisions of ASC 718-20. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award.

Determining Fair Value of Stock Options

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

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

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

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

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

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

POWER INTEGRATIONS, INC.

NOTES TO 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 condition 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 losses and other relevant information. Account balances are recorded 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 December 31, 2010 and 2009, approximately 76% and 63% of accounts receivable, respectively, were concentrated with ten customers. As of December 31, 2010 and 2009, one customer, a distributor of the Company's products, accounted for more than 10% of accounts receivable. No other customers accounted for more than 10% of accounts receivable in the periods mentioned.

Indemnifications

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

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of December 31, 2010. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

Recently Issued Accounting Pronouncements

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

In January 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures* (Topic 820): Improving Disclosures about Fair Value Instruments. ASU No. 2010-06 amends ASC 820 to require additional disclosures regarding fair value measurements. Specifically, the ASU requires entities to disclose the amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy, to disclose reasons for any transfers in or out of Level 3 and to separately disclose information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements. In addition, the ASU also amends ASC 820 to clarify certain existing disclosure requirements. Except for the requirement to disclose information about purchases, sales, issuances and settlements in the reconciliation of recurring Level 3 measurements separately, the amendments to ASC 820 made by ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of these provisions of ASU No. 2010-06 did not have a material impact on the Company's consolidated financial statements. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements is effective for interim and annual reporting periods beginning after December 15, 2010. The Company does not expect the adoption of the remaining provisions of this ASU to have a material impact on the Company's consolidated financial statements.

3. COMMITMENTS AND CONTINGENCIES:

From time to time in the ordinary course of business, the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company (see Note 9). In accordance with ASC 450-10 (formerly SFAS No. 5, *Accounting for Contingencies*), the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

Facilities

The Company owns its main executive, administrative, manufacturing and technical offices in San Jose, California.

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

Future minimum lease payments under all non-cancelable operating lease agreements as of December 31, 2010 are as follows (in thousands):

Fiscal Year	
2011	\$ 660
2012	379
2013	157
2014	22
2015	22
Thereafter	58
Total minimum lease payments	\$ 1,298

Total rent expense amounted to \$1.3 million, \$0.8 million and \$0.7 million in the years ended December 31, 2010, 2009 and 2008, respectively.

Purchase Obligations

The Company had no capital leasing arrangements as of December 31, 2010. At December 31, 2010 the Company had \$18.0 million of non-cancelable purchase obligations, consisting primarily of inventory related items. One of the Company's wafer agreements has a minimum purchase commitment.

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

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

Lease line

In February 2011, the Company entered into an agreement to provide a lease line for the financing of capital equipment, in connection with the Company's investment in SemiSouth Laboratories. Under the term of the agreement, SemiSouth Laboratories can borrow up to \$15.5 million through January 2013. As it is not possible to predict when or by how much, if any, the lease line will be utilized, the potential payments are not disclosed.

4. FAIR VALUE MEASUREMENTS:

ASC 820-10, *Fair Value Measurements*, clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820-10 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices for identical assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3)

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

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

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

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

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

The following table presents the changes in the Company's Level 3 assets, which are measured at fair value on a recurring basis, for the year ended December 31, 2010 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs (Level 3) Note Receivables
Beginning balance at January 1, 2010	\$
Issuances	6,750

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Conversion in connection with acquisition (see Note 10)	(1,750)
Conversion to cost-method investment (see Note 11)	(5,000)
Ending balance at December 31, 2010	\$

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. STOCK PLANS AND SHARE BASED COMPENSATION:

Preferred Stock

The Company is authorized to issue 3,000,000 shares of \$0.001 par value preferred stock, none of which were issued or outstanding during each of the two years ended December 31, 2010 and 2009.

Stock Plans

As of December 31, 2010, the Company had five stock-based employee compensation plans, the Plans, which are described below.

2007 Equity Incentive Plan

The 2007 Equity Incentive Plan (the 2007 Plan) was adopted by the board of directors on September 10, 2007 and approved by the stockholders on November 7, 2007 as an amendment and restatement of the 1997 Stock Option Plan (the 1997 Plan). The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards (RSUs), stock appreciation rights, performance stock awards and other stock awards to employees, directors and consultants. As of December 31, 2010, the maximum remaining number of shares that may be issued under the 2007 Plan was 7,604,453 shares, which consists of the shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options and stock awards under the 1997 Plan. Pursuant to the 2007 Plan, the exercise price for incentive stock options and nonstatutory stock options is generally at least 100% of the fair market value of the underlying shares on the date of grant. Options generally vest over 48 months measured from the date of grant. Options generally expire no later than ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

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

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

1997 Stock Option Plan

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the 1997 Plan), whereby the board of directors may grant incentive stock options and nonstatutory stock options to key employees, directors and consultants to purchase the Company's common stock. 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

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

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. 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 increases 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. Effective November 2007, the board of directors determined that no further options would be granted under the 1997 Plan, and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options under the 1997 Plan were transferred to the 2007 Equity Incentive Plan. All outstanding options would continue to be governed and remain outstanding in accordance with their existing terms.

1997 Outside Directors Stock Option Plan

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

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

1998 Nonstatutory Stock Option Plan

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the 1998 Plan), whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to the extent that such options do not require approval of the Company's stockholders. The 1998 Plan has not been approved by the Company's stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. As of December 31, 2010, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000 shares. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

POWER INTEGRATIONS, INC.**NOTES TO 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 offering period, or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Prior to February 1, 2009, each offering period consisted of four consecutive purchase periods of approximately six months duration, or such other number or duration as the board determined. Beginning February 1, 2009, each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of December 31, 2010, 2,220,875 shares had been purchased and 779,125 shares were reserved for future issuance under the Purchase Plan.

Stock-based Compensation

The Company applies the provisions of ASC 718-10. Under the provisions of ASC 718-10, the Company recognizes the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. The Company uses estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation to recognize. See Note 2, *Summary of Significant Accounting Policies*, for a description of the Company's assumptions used in the calculation of its share-based compensation expense. Changes in these estimates could result in changes to the Company's compensation charges.

The following table presents the functional allocation of all share-based compensation and related expense included in the accompanying consolidated statements of income (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Cost of revenues	\$ 686	\$ 790	\$ 3,481
Research and development	4,107	4,371	11,773
Sales and marketing	2,594	2,548	11,878
General and administrative	3,334	3,619	7,832
Total	\$ 10,721	\$ 11,328	\$ 34,964

The Company recorded \$10.7 million in pre-tax share-based compensation expenses, including expenses related to grants of stock options, performance-based awards, restricted stock units and purchase rights under the Purchase Plan during the year ended December 31, 2010. These expenses consisted of approximately \$5.2 million related to stock options, \$3.0 million related to performance-based awards, \$1.5 million related to restricted stock units and \$1.1 million related to the Company's Purchase Plan, reduced by \$0.1 million for net compensation capitalized into inventory.

The Company recorded \$11.3 million in pre-tax share-based compensation expenses, including expenses related to grants of stock options, performance-based awards and purchase rights under the Purchase Plan during the year ended December 31, 2009. These expenses consisted of approximately \$6.9 million related to stock options, \$2.2 million related to performance-based awards, \$2.1 million related to the Company's Purchase Plan, and approximately \$0.1 million for net amortized compensation expense associated with capitalized inventory.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

costs. The Company recorded \$35.0 million in pre-tax share-based compensation expenses, including expenses related to grants of stock options and purchase rights under the Purchase Plan during the year ended December 31, 2008. These expenses consisted of approximately \$32.1 million related to stock options, which includes \$19.3 million related to the Company's tender offer (see Note 6 below for information on the Company's tender offer), \$2.7 million related to the Company's Purchase Plan, and approximately \$0.1 million for net amortized compensation expense associated with capitalized inventory costs.

As of December 31, 2010, there were approximately (i) \$7.7 million, net of expected forfeitures, of total unrecognized compensation costs related to stock options, which are expected to be recognized over a weighted-average period of 2.2 years; (ii) the total unrecognized compensation cost related to restricted stock units was approximately \$6.7 million, net of expected forfeitures, which the Company will amortize on a straight-line basis over a weighted-average period of 3.4 years; and (iii) the total unrecognized compensation cost related to the Purchase Plan was approximately \$0.1 million, which the Company will amortize on a straight-line basis over periods of up to six months. The Company has amortized all outstanding performance stock unit awards as of December 31, 2010.

The Company received net proceeds of \$26.3 million from option exercises and Purchase Plan purchases during the year ended December 31, 2010.

The weighted-average fair value of options granted is estimated on the date of grant using the Black-Scholes model with the following weighted-average assumptions used for share-based payment awards during the years ended December 31, 2010, 2009 and 2008:

	2010	2009	2008
Stock Options:			
Expected volatility	45%-48%	39%-48%	42%-54%
Risk-free interest rate	1.53%-2.25%	1.76%-2.47%	2.18%-3.16%
Expected term (in years)	5.12	5.01	4.97
Expected dividend yield	0.54%-0.62%	0.34%-0.52%	0.54%

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

	2010	2009	2008
Employee Stock Purchase Plan:			
Expected volatility	36%-43%	35%-56%	35%-46%
Risk-free interest rate	0.17%-0.20%	0.28%-0.39%	1.88%-4.96%
Expected term (in years)	0.5	0.5	1.0
Expected dividend yield	0.52%-0.55%	0.34%-0.52%	
Weighted-average estimated fair value of the purchase rights granted during the year	\$8.65	\$7.03	\$10.55

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes option activity under the Company's option plans (prices are weighted-average prices):

	Shares	Price	Weighted-average remaining contractual term (years)	Aggregate intrinsic value in (\$000)
Options outstanding, January 1, 2008	8,186,224	\$ 21.57		
Granted	1,602,984	\$ 28.20		
Exercised	(1,157,628)	\$ 17.81		
Cancelled	(2,650,590)	\$ 27.65		
Options outstanding, December 31, 2008	5,980,990	\$ 21.38		
Granted	876,895	\$ 21.28		
Exercised	(929,633)	\$ 17.93		
Cancelled	(203,982)	\$ 30.75		
Options outstanding, December 31, 2009	5,724,270	\$ 21.65		
Granted	218,000	\$ 35.46		
Exercised	(1,263,683)	\$ 18.15		
Cancelled	(245,928)	\$ 33.25		
Options outstanding at December 31, 2010	4,432,659	\$ 22.68	5.03	\$ 77,475
Exercisable at December 31, 2010	3,551,810	\$ 22.19	4.21	\$ 63,810
Vested and expected to vest at December 31, 2010	4,358,756	\$ 22.63	4.97	\$ 76,420

The weighted-average grant-date fair value of options granted for the years ended December 31, 2010, 2009 and 2008 was \$14.82, \$8.53 and \$11.91, respectively. The total intrinsic value of options exercised during the years ending December 31, 2010, 2009 and 2008 was \$27.1 million, \$11.4 million and \$14.3 million, respectively.

Options issued under the 1997 and 1998 plans may be exercised at any time prior to their expiration. The Company has a repurchase right that lapses over time, under which it has the right, upon termination of an option holder's employment or service with the Company, at its discretion, to repurchase any unvested shares issued under the 1997 and 1998 plans at the original purchase price. Under the terms of the option plans, an option holder may not sell shares obtained upon the exercise of an option until the option has vested as to those shares. As of December 31, 2010, 2009 and 2008, there were no shares of common stock issued under the 1997 and 1998 plans that are subject to repurchase by the Company. Options issued under the Directors Plan are exercisable upon vesting.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the stock options outstanding at December 31, 2010:

Options Outstanding				Options Vested and Exercisable		
		Weighted Average Remaining Contractual Term		Weighted Average Exercise Price	Number Vested	Weighted Average Exercise Price
Exercise Price	Number Outstanding					
\$12.10 \$15.74	222,775	1.08		\$ 14.04	222,775	\$ 14.04
\$15.75 \$17.75	782,959	3.63		\$ 17.37	763,394	\$ 17.36
\$17.76 \$18.95	404,947	2.59		\$ 18.60	383,863	\$ 18.62
\$19.02 \$20.20	166,667	3.63		\$ 19.45	156,332	\$ 19.42
\$20.21 \$21.57	892,579	7.86		\$ 21.10	378,617	\$ 21.08
\$21.58 \$22.97	79,789	4.58		\$ 22.52	68,006	\$ 22.46
\$22.98 \$24.59	161,736	5.19		\$ 24.11	115,976	\$ 24.10
\$24.60 \$26.75	828,138	5.86		\$ 25.92	787,891	\$ 25.96
\$26.76 \$32.54	689,160	4.66		\$ 28.62	563,298	\$ 27.87
\$32.55 \$38.07	203,909	6.32		\$ 35.92	111,658	\$ 34.15
\$12.10 \$38.07	4,432,659	5.03		\$ 22.68	3,551,810	\$ 22.19

Performance-based Awards

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

During the year ended December 31, 2010, the Company issued 91,650 performance-based awards to employees and executives. As net revenue and non-GAAP operating income are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, were recognized over the twelve month service period based on an assessment of the achievement of the performance targets. The fair value of these performance-based awards was determined using the fair value of the Company's common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. In January 2011, it was determined that the Company had reached the maximum level of the established performance targets for the 2010 performance-based awards. Accordingly, the performance-based awards, which were fully vested, were released to the Company's employees and executives in 2011.

In January 2010, it was determined that the Company had reached the maximum level of the established performance targets for the performance-based awards granted in 2009. Accordingly, 119,200 performance-based awards were released to the Company's employees and executives in the first quarter of 2010. The Company's 2009 revenue and non-GAAP operating income amounts exceeded the established maximum threshold, and therefore the released quantity of shares represented the maximum level of the established target. Of this amount 23,392 shares were purchased by the Company and retired for executive income tax withholding.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of performance-based awards outstanding as of December 31, 2010, and activity during the two years then ended, is as follows:

	Shares (in thousands)	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2009			
Granted	119		
Vested			
Forfeited or expired			
Outstanding at January 1, 2010	119		
Granted	92		
Vested	(121)		
Forfeited or expired	(5)		
Outstanding at December 31, 2010	85		\$ 3,420

The weighted average grant-date fair value per share of performance-based awards granted in the years ended December 31, 2010 and 2009 was approximately \$34.85 and \$18.66, respectively. No performance-based awards were granted in the year ended December 31, 2008. The grant date fair value of awards vested in the year ended December 31, 2010 was \$3.0 million. No performance-based awards vested in the year ended December 31, 2009.

Restricted Stock Units (RSUs)

The Company grants restricted stock units to employees under the 2007 Plan. RSUs are straight-line vested over a four year period, subject to the employee's continued service with the Company over that period. RSUs convert into shares of the Company's common stock upon vesting on a one-for-one basis. Fair value of the RSUs is determined using the fair value of the Company's common stock on the date of grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. Compensation is recognized on a straight-line basis over the requisite service period of each grant adjusted for estimated forfeitures. Each RSU award granted from the 2007 plan will reduce the number of options available for issuance by 2.0 shares.

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

A summary of RSUs outstanding as of December 31, 2010, and activity during the two years then ended, is as follows:

	Shares (in thousands)	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2009			
Granted	13		
Vested			
Forfeited or expired			
Outstanding at January 1, 2010	13		
Granted	259		
Vested	(4)		
Forfeited or expired	(8)		
Outstanding at December 31, 2010	260	1.87	\$ 10,422
Expected to vest at December 31, 2010	226	1.78	\$ 9,071

The weighted-average grant-date fair value of RSUs awarded in the years ended December 31, 2010 and 2009 was approximately \$36.44 and \$33.17 per share, respectively. No RSUs were granted in the year ended December 31, 2008. The grant date fair value of awards vested in the year ended December 31, 2010 was \$0.2 million. No RSU awards vested in the year ended December 31, 2009.

Non-employee Stock Options

In 2010, 2009 and 2008, the Company granted no non-employee options. As of December 31, 2010, there were no non-employee options outstanding.

Shares Reserved

As of December 31, 2010, the Company had 3.7 million shares of common stock reserved for future issuance under stock option and stock purchase plans.

6. TENDER OFFER:

In December 2008 the Company offered to purchase for cash certain eligible stock options from certain eligible employees (defined as those employees of the Company, or one of its subsidiaries as of December 3, 2008 (including officers), who continue to be employed through the expiration time of the tender offer). The stock options that were subject to this offer were those stock options to purchase the Company's stock that had each of the following characteristics (the "Eligible Options");

Were granted between January 1, 2004 and September 15, 2008 to eligible employees, and

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Were granted under the Company's 1997 Stock Option Plan, as amended, or the Company's 2007 Equity Incentive Plan, as amended; and

Were outstanding on December 3, 2008 and were outstanding as of December 31, 2008.

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

The purpose of this tender offer was to provide incentive to employees whose options were underwater given the current unfavorable market environment, and to reduce the amount of option overhang by buying underwater options at less than fair market value. The total number of employees that accepted the tender offer was 354, including 7 executive officers of the Company. The total cash amount that the Company offered to pay for each share subject to an eligible option that was tendered was \$2 per share if the eligible option was granted in 2004 or 2005, and \$4 per share if the eligible option was granted in 2006, 2007 or 2008 (before September 15, 2008). All cash payments for properly tendered eligible options were made in January 2009. A total of \$9.0 million was accrued at December 31, 2008, related to this cash payment and is reflected as accrued payment to employees for tender offer in the Company's consolidated statement of stockholders equity.

In accordance with ASC 718-10, the tender offer is considered an option modification, and following the guidance of ASC 718-10, the Company accelerated the stock-based compensation expense for these tendered options for a total of \$19.3 million in the fourth quarter of 2008. This amount was reflected in the cost of revenues and operating expense captions in the Company's consolidated statement of income at December 31, 2008.

The following table presents the functional allocation of share-based compensation related to the tender offer included in the accompanying consolidated statement of income (in thousands):

	Year Ended December 31, 2008
Cost of revenues	\$ 1,959
Research and development	6,761
Sales and marketing	6,525
General and administrative	4,073
Total	\$ 19,318

7. TAXES:*Income Taxes*

U.S. and foreign components of income (loss) before income taxes were (in thousands):

	Year Ended December 31,		
	2010	2009	2008
U.S. operations	\$ 22,312	\$ 5,093	\$ (5,260)
Foreign operations	39,493	25,430	15,984
Total pretax income	\$ 61,805	\$ 30,523	\$ 10,724

Undistributed earnings of the Company's foreign subsidiaries of approximately \$147.6 million at December 31, 2010, are considered to be indefinitely reinvested and, accordingly, no provision for Federal income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. Federal and State income taxes (subject to an adjustment for foreign tax credits, where applicable) and withholding taxes payable to various foreign countries. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of the provision for income taxes are as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Current provision:			
Federal	\$ 9,179	\$ 5,469	\$ 6,928
State	585	3,347	737
Foreign	98	476	1,235
	9,862	9,292	8,900
Deferred provision (benefit):			
Federal	2,280	(1,201)	763
State	160	(811)	(608)
Foreign	39	(26)	(134)
	2,479	(2,038)	21
Total	\$ 12,341	\$ 7,254	\$ 8,921

The Company is entitled to a deduction for Federal and State tax purposes with respect to employees' stock option activity. The net reduction in taxes otherwise payable in excess of any amount credited to income tax benefit has been reflected as an adjustment to additional paid-in capital. For 2010, 2009 and 2008, the benefit arising from employee stock option activity that resulted in an adjustment to additional paid in capital was approximately \$2.9 million, \$1.6 million and \$1.9 million, respectively.

The provision for income taxes differs from the amount, which would result by applying the applicable Federal income tax rate to income before provision for income taxes as follows:

	2010	2009	2008
Provision computed at Federal statutory rate	35.0%	35.0%	35.0%
State tax provision, net of Federal benefit	1.3	0.5	(1.6)
Business tax credits	(5.6)	(7.5)	(12.9)
Stock-based compensation	2.6	4.5	66.3
Foreign income taxed at different rate	(14.7)	(15.5)	(7.9)
FIN 48 interest and penalties	0.7	(0.1)	7.0
FIN 48 releases	(0.4)		(2.8)
Valuation allowance	0.2	7.9	
Other	0.9	(1.0)	0.1
Total	20.0%	23.8%	83.2%

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of the net deferred income tax asset were as follows (in thousands):

	December 31,	
	2010	2009
Deferred Tax Assets		
Tax credit carry-forwards	\$ 5,375	\$ 5,170
Inventory reserves		84
Other reserves and accruals	5,102	4,082
Depreciation	292	1,593
Stock compensation	7,609	8,013
Acquired intangibles	25	26
	18,403	18,968
Valuation Allowance	(3,547)	(2,989)
Net deferred tax asset	\$ 14,856	\$ 15,979

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

As of December 31, 2010, the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets primarily due to California budget legislation as the Company believes that it is not more likely than not that the deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions.

As of December 31, 2010, the Company had California research and development tax credit carryforwards of approximately \$11.1 million. There is no expiration of research and development tax credit carryforwards for the state of California. As of December 31, 2010, the company had Federal research and development tax credit carryforwards of approximately \$1.0 million, and Canadian scientific research and experimental development tax credit carryforwards of \$1.0 million, which will start to expire in 2026 and 2027, respectively, if unutilized.

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

POWER INTEGRATIONS, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Unrecognized Tax Benefits*

The Company applies the provisions of ASC 740-10, relating to accounting for uncertain income taxes.

Reconciliation of the Beginning and Ending Amount of Unrecognized Tax Benefits

Unrecognized Tax Benefits Balance at January 1, 2008	\$ 17,406
Gross Increases for Tax Positions of Current Year	4,593
Gross Decreases for Tax Positions of Prior Years	
Settlements	(1,319)
Lapse of Statute of Limitations	
Unrecognized Tax Benefits Balance at December 31, 2008	20,680
Gross Increases for Tax Positions of Current Year	4,189
Gross Decreases for Tax Positions of Prior Years	
Settlements	
Lapse of Statute of Limitations	
Unrecognized Tax Benefits Balance at December 31, 2009	24,869
Gross Increases for Tax Positions of Current Year	5,269
Gross Decreases for Tax Positions of Prior Years	(227)
Settlements	
Lapse of Statute of Limitations	
Unrecognized Tax Benefits Balance at December 31, 2010	\$ 29,911

The Company's total unrecognized tax benefits as of December 31, 2010, 2009 and 2008 was \$29.9 million, \$24.9 million and \$20.7 million, respectively. An income tax benefit would be recorded if these unrecognized tax benefits are recognized. Although it is possible some of the unrecognized tax benefits could be settled within the next 12 months, the Company cannot reasonably estimate the outcome at this time.

As of December 31, 2010, the Company had accrued \$3.5 million for payment of such interest and penalties, which was classified as non-current taxes payable. Approximately, \$0.4 million of interest and penalties were included in the Company's provision for income taxes for the year-ended December 31, 2010.

8. GOODWILL, INTANGIBLE ASSETS AND ASSET IMPAIRMENT:

Goodwill of \$14.8 million was recorded on the Company's consolidated balance sheet as of December 31, 2010. The \$13.0 million of goodwill acquired in 2010 resulted from the acquisitions of Qspeed Semiconductor and an early-stage research and development company (see Note 10). In the fourth quarter of 2010, goodwill was evaluated in accordance with ASC 350-10, *Goodwill and Other Intangible Assets*, and no impairment charge was deemed necessary during the year ended December 31, 2010.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in the carrying amount of goodwill during the years ended December 31, 2010 and 2009 were as follows (in thousands):

	Year Ended December 31, 2010
Balance at January 1, 2009	\$ 1,824
Goodwill acquired during the period	
Goodwill adjustments	
Balance at December 31, 2009	\$ 1,824
Goodwill acquired during the period	13,002
Goodwill adjustments	
Ending balance at December 31, 2010	\$ 14,826

Intangible assets consist primarily of acquired licenses, in-process research and development and patent rights, and are reported net of accumulated amortization. In the year ended December 31, 2010, the Company acquired the above-mentioned early-stage research and development company, resulting in the addition of in-process research and development of \$4.7 million, and the Company acquired Qspeed Semiconductor resulting in the addition of customer relationships of \$0.9 million, which will be amortized over a term of eight years, and developed technology of \$1.8 million, which will be amortized over a term of ten years (see Note 10). The Company amortizes the cost of all intangible assets over the term of the acquired license or patent rights, which range from five to twelve years, with the exception of \$4.7 million of in-process research and development which will be amortized once the development is completed and products are available for sale. Amortization for acquired intangible assets was approximately \$0.7 million in both 2010 and 2009. The Company does not believe there is any significant residual value associated with the following intangible assets (in thousands):

	December 31, 2010			December 31, 2009		
	Gross	Accumulated Amortization	Net (in thousands)	Gross	Accumulated Amortization	Net
In-process research and development	\$ 4,690	\$	\$ 4,690	\$	\$	\$
Technology licenses	3,000	(1,425)	1,575	3,000	(1,125)	1,875
Patent rights	1,949	(1,760)	189	1,949	(1,542)	407
Developed technology	2,920	(489)	2,431	1,140	(326)	814
Customer relationships	910		910			
Other intangibles	37	(37)		37	(34)	3
Total intangible assets	\$ 13,506	\$ (3,711)	\$ 9,795	\$ 6,126	\$ (3,027)	\$ 3,099

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

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

Fiscal Year	Estimated Amortization(1) (in thousands)
2011	943
2012	755
2013	755
2014	755
2015	592
Thereafter	5,995
Total	\$ 9,795

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

In 2008 the Company performed an impairment analysis of intangible assets related to a certain patent, licensed technology and customer relationships as there was an indicator that the carrying amount of the assets may not be recoverable. The Company determined that these intangible assets were no longer useful in the Company's manufacturing and sales processes. The Company reduced its gross intangible assets by \$2.7 million and recorded an impairment charge of \$2.0 million, which represented the total net book value of the intangible assets. The Company deemed that there was no further value to these impaired intangible assets. The charge was reflected in the Intangible asset impairment caption in the accompanying consolidated statements of income.

9. LEGAL PROCEEDINGS:

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as Fairchild) in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding \$33,981,781 in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages award. Fairchild also raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to \$6,116,720, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

injunction for 90 days to permit Fairchild to petition the Federal Circuit Court of Appeals for a further stay. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement, and the parties completed post-trial briefing on the issue of willfulness shortly thereafter. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents. The Court also invited briefing on enhanced damages and attorneys' fees, and Fairchild filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2010, the Court entered final judgment in favor of the Company for a total damages award of \$12.9 million. Fairchild has filed a notice of appeal challenging the final judgment and a number of the underlying rulings.

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

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly-owned subsidiary System General Corporation (SG) in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought

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

these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On February 10, 2011, the Court issued an order maintaining the stay with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case pending the appeal in that case. On February 18, the Court rescheduled the trial to August 8, 2011 in view of a scheduling conflict with the previously-scheduled July dates.

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In February, 2010, Fairchild and System General (SG) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The proceedings are still in their early stages, with no hearings or trial currently scheduled. The suits assert four Chinese patents and seek an injunction and damages of approximately \$17 million. Power Integrations Netherlands has filed invalidation proceedings for all four asserted SG patents in the People's Republic of China Patent Reexamination Board (PRB) of the State Intellectual Property Office (SIPO), and all four challenges were accepted by the PRB, with hearings conducted in September 2010 and rulings expected in the coming months. The Company believes the Fairchild and SG claims are without merit and intends to contest them vigorously.

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

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

The Company is unable to predict the outcome of legal proceedings with certainty, and there c