POWER INTEGRATIONS INC

FORM 10-Q
(Quarterly Report)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2012

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	**94-3065014**
(State or other jurisdiction of Incorporation or organization)	**(I.R.S. Employer Identification No.)**

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

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

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

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

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

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

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

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

Class	Shares Outstanding at July 30, 2012
Common Stock, $.001 par value	28,832,820

POWER INTEGRATIONS, INC.

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words “would”, “could”, “will”, “may”, “expect”, “believe”, “should”, “anticipate”, “outlook”, “if”, “future”, “intend”, “plan”, “estimate”, “predict”, “potential”, “targets”, “seek” or “continue” and similar words and phrases, including the negatives of these terms, or other variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under Item 1A of Part II — “Risk Factors,” Item 2 of Part I — “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this Quarterly Report on Form 10-Q, including: our quarterly operating results are volatile and difficult to predict, and if we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly; intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products; if demand for our products declines in our major end markets, our net revenues will decrease; if we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability; if we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies; we are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of tax related position; and our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we have no obligation (and expressly disclaim any obligation) to update or alter any forward-looking statements, whether as a result of new information or otherwise except as otherwise required by securities regulations.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)
(In thousands)

	June 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 73,360	$ 139,836
Short-term marketable securities	60,068	40,899
Accounts receivable, net of allowances of $257 and $215 in 2012 and 2011, respectively (Note 2)	17,966	9,396
Inventories	48,555	52,010
Deferred tax assets	893	892
Prepaid expenses and other current assets	7,758	7,068
Total current assets	208,600	250,101
LONG-TERM MARKETABLE SECURITIES	—	32,041
PROPERTY AND EQUIPMENT, net	91,738	88,241
INTANGIBLE ASSETS, net	51,422	8,852
GOODWILL	77,354	14,786
DEFERRED TAX ASSETS	7,120	12,387
OTHER ASSETS	43,380	26,511
Total assets	$ 479,614	$ 432,919
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 21,108	$ 16,532
Accrued payroll and related expenses	6,650	5,911
Taxes payable	37,936	—
Deferred tax liabilities	1,961	—
Deferred income on sales to distributors	11,270	7,883
Other accrued liabilities	2,514	2,305
Total current liabilities	81,439	32,631
LONG-TERM INCOME TAXES PAYABLE	7,364	34,368
DEFERRED TAX LIABILITIES	4,185	—
PENSION LIABILITY	622	—
Total liabilities	93,610	66,999
COMMITMENTS AND CONTINGENCIES (Notes 9, 11 and 12)		
STOCKHOLDERS' EQUITY:		
Common stock	29	28
Additional paid-in capital	181,203	158,646
Accumulated other comprehensive income	145	50
Retained earnings	204,627	207,196
Total stockholders' equity	386,004	365,920
Total liabilities and stockholders' equity	$ 479,614	$ 432,919

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

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(unaudited)
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
NET REVENUES	$ 76,382	$ 80,184	$ 148,155	$ 156,946
COST OF REVENUES	38,627	42,558	75,807	82,897
GROSS PROFIT	37,755	37,626	72,348	74,049
OPERATING EXPENSES:				
Research and development	12,066	10,195	22,706	20,218
Sales and marketing	9,176	8,104	17,315	16,352
General and administrative	7,100	6,141	14,193	12,616
Total operating expenses	28,342	24,440	54,214	49,186
INCOME FROM OPERATIONS	9,413	13,186	18,134	24,863
OTHER INCOME				
Other income, net	195	461	810	903
Total other income	195	461	810	903
INCOME BEFORE PROVISION FOR INCOME TAXES	9,608	13,647	18,944	25,766
PROVISION FOR INCOME TAXES	16,784	3,048	18,659	5,313
NET INCOME (LOSS)	$ (7,176)	$ 10,599	$ 285	$ 20,453
EARNINGS (LOSS) PER SHARE:				
Basic	$ (0.25)	$ 0.37	$ 0.01	$ 0.71
Diluted	$ (0.25)	$ 0.35	$ 0.01	$ 0.68
SHARES USED IN PER SHARE CALCULATION:				
Basic	28,619	28,938	28,423	28,784
Diluted	28,619	30,346	29,624	30,271

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

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME / (LOSS)
(unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income (loss)	$ (7,176)	$ 10,599	$ 285	$ 20,453
Other comprehensive income, net of tax:				
Unrealized gain (loss) on marketable securities	(129)	—	162	—
Foreign currency translation adjustments	(124)	23	(67)	72
Total other comprehensive income (loss)	$ (253)	$ 23	$ 95	$ 72
Total comprehensive income (loss)	$ (7,429)	$ 10,622	$ 380	$ 20,525

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

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(In thousands)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 285	$ 20,453
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	7,627	7,472
Amortization of intangibles	1,479	486
Gain on sale of property and equipment	(1)	(41)
Stock-based compensation expense	6,673	4,948
Amortization of premium on marketable securities	567	859
Non-cash interest income from SemiSouth note	(780)	—
Deferred income taxes	4,834	826
Provision for (reduction in) accounts receivable allowances	(14)	37
Excess tax benefit from stock options exercised	(474)	(697)
Tax benefit associated with employee stock plans	1,531	1,538
Change in operating assets and liabilities:		
Accounts receivable	(5,336)	(2,392)
Inventories	14,119	7,915
Prepaid expenses and other assets	2,834	3,048
Accounts payable	3,795	(4,260)
Taxes payable and accrued liabilities	8,784	1,468
Deferred income on sales to distributors	3,387	(1,021)
Net cash provided by operating activities	49,310	40,639
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(8,754)	(12,519)
Proceeds from sale of property and equipment	2	2,249
Acquisitions	(113,360)	(6,914)
Other assets	—	(808)
Increase in financing lease receivable	(383)	(7,821)
Collections of financing lease receivable	299	205
Loan to SemiSouth	(18,000)	(3,000)
Purchases of marketable securities	—	(11,508)
Proceeds from maturities of marketable securities	12,468	6,630
Net cash used in investing activities	(127,728)	(33,486)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock under employee stock plans	14,321	14,246
Repurchase of common stock	—	(4,384)
Payments of dividends to stockholders	(2,853)	(2,885)
Excess tax benefit from stock options exercised	474	697
Net cash provided by financing activities	11,942	7,674

	Six Months Ended June 30,	
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(66,476)	14,827
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	139,836	155,667
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 73,360	$ 170,494
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unpaid property and equipment	$ 1,578	$ 3,510
Receipt of SemiSouth purchase option	$ 6,216	$ —
Acquisition net asset value adjustment (Note 14)	$ 2,358	$ —
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for income taxes, net of refunds	$ 2,076	$ 310

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

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:

The condensed consolidated financial statements include the accounts of Power Integrations, Inc., a Delaware corporation (the “Company”), and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2011 included in its Form 10-K filed on February 29, 2012 , with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

No material changes have been made to the Company's significant accounting policies disclosed in Note 2, *Summary of Significant Accounting Policies* , in its Annual Report on Form 10-K, filed on February 29, 2012 , for the year ended December 31, 2011 , except for the changes discussed below. The accounting policy information below is to aid in the understanding of the financial information disclosed.

Cash and Cash Equivalents

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

Marketable Securities

In the first quarter of 2012, the Company changed its investment policy to permit the sale of long-term and short-term marketable securities prior to their stated maturity date. The Company generally holds securities until maturity; however, they may now be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments. As a result of this change in policy the Company classifies its investment portfolio as available-for-sale as opposed to held-to-maturity beginning March 31, 2012. Prior to March 31, 2012, the Company classified its investments as held-to-maturity. In connection with this change in investment policy the Company classified all investments with an original maturity date greater than three months as short-term investments in its Condensed Consolidated Balance Sheet. The Company's short-term investment portfolio is invested in highly liquid financial instruments with maturities greater than three months. As of June 30, 2012 and December 31, 2011 , the Company's marketable securities consisted of U.S. government-backed securities, municipal bonds, corporate commercial paper, certificates of deposit and other high-quality commercial securities.

Amortized cost and estimated fair market value of investments classified as available-for-sale at June 30, 2012 , are as follows (in thousands):

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Certificates of deposit	$ 10,000	$ —	$ —	$ 10,000
Corporate securities	14,361	25	—	14,386
Total	$ 24,361	$ 25	$ —	$ 24,386
Investments due in 4-12 months:				
Corporate securities	$ 20,875	$ 71	$ —	$ 20,946
Total	$ 20,875	$ 71	$ —	$ 20,946
Investments due in more than 12 months:				
Corporate securities	$ 14,670	$ 66	$ —	$ 14,736
Total	$ 14,670	$ 66	$ —	$ 14,736
Total investment securities	$ 59,906	$ 162	$ —	$ 60,068

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	$ 9,849	$ —	$ —	$ 9,849
Corporate securities	6,098	9	(1)	6,106
Total	$ 15,947	$ 9	$ (1)	$ 15,955
Investments due in 4-12 months:				
Corporate securities	$ 24,801	$ 179	$ (23)	$ 24,957
Certificates of deposit	10,000	1	—	10,001
Total	$ 34,801	$ 180	$ (23)	$ 34,958
Investments due in more than 12 months:				
Corporate securities	$ 32,041	$ 5	$ (178)	$ 31,868
Total	$ 32,041	$ 5	$ (178)	$ 31,868
Total investment securities	$ 82,789	$ 194	$ (202)	$ 82,781

As of June 30, 2012 the Company had no marketable securities in an unrealized loss position. The Company evaluated the nature of the investments with a loss position at December 31, 2011 , which were primarily high-quality commercial securities, and determined the unrealized losses were not other-than-temporary.

Revenue Recognition

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Approximately 73% of the Company's net product sales were made to distributors in the six months ended June 30, 2012 , and 71% in the twelve months ended December 31, 2011 . The Company applies the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the Company's customer. The Company evaluates whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to

collectability, the Company performs credit checks for new customers and performs ongoing evaluations of its existing customers' financial condition and requires letters of credit whenever deemed necessary.

Sales to international OEM customers and merchant power supply manufacturers that are shipped from the Company's facility in California are pursuant to “delivered at frontier” (“DAF”) shipping terms. 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. Sales to international OEMs and merchant power supply manufacturers for shipments from the Company's facility outside of the United States are pursuant to “EX Works” ("EXW") shipping terms, 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 pursuant to “free on board” (“FOB”) point of origin shipping terms 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.

Sales to most of our distributors are made under terms allowing certain price adjustments and rights of return on the Company's products held by its 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 the Company's distributors report that they have sold the Company's products to their customers. The Company's recognition of such distributor revenue is based on point of sale reports received from the distributors, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to the Company except pursuant to warranty terms. The gross profit that is deferred as a result of this policy is reflected as “deferred income on sales to distributors” in the accompanying condensed consolidated balance sheets. The total deferred revenue as of June 30, 2012 and December 31, 2011 was approximately $21.7 million and $16.7 million , respectively. The total deferred cost as of June 30, 2012 and December 31, 2011 was approximately $10.4 million and $8.8 million , respectively.

Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At or soon after the distributor invoices its customer, the distributor submits a “ship and debit” price adjustment claim to the Company to adjust the distributor's cost from the standard price to the pre-approved lower price. After verification by the Company, a credit memo is issued to the distributor for the ship and debit claim. The Company maintains a reserve for unprocessed claims and future ship and debit price adjustments. The reserve appears as a reduction to accounts receivable in the Company's accompanying consolidated balance sheets. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on the deferred revenue and deferred margin ultimately recognized. To evaluate the adequacy of its reserves, the Company analyzes historical ship and debit payments and levels of inventory in the distributor channels.

Sales to certain distributors of the Company are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, product revenue is recognized upon shipment and title transfer assuming all other revenue recognition criteria are met.

Common Stock Repurchases and Common Stock Dividend

In February 2011, the board of directors authorized the use of $50.0 million for the repurchase of the Company's common stock, with repurchases to be executed according to certain pre-defined price/volume guidelines set by the board of directors. In the twelve months ended December 31, 2011 , the Company repurchased 1.5 million shares for a total cost of $50.0 million , concluding this repurchase program. In November 2011, the board of directors authorized the use of an additional $30.0 million for the repurchase of the Company's common stock, and in March 2012, the Company canceled its $30.0 million stock repurchase program in connection with its purchase agreement to acquire CT-Concept Technologie AG. Refer to note 14, *Acquisition* , for acquisition details.

In October 2010, the Company's board of directors declared four quarterly cash dividends in the amount of $0.05 per share to be paid to stockholders of record at the end of each quarter in 2011. The first quarterly dividend payment of approximately $1.4 million was made on March 31, 2011, the second quarterly dividend payment of $1.4 million was made on June 30, 2011 , the third payment of $1.4 million was made on September 30, 2011, and the final 2011 dividend payment of $1.4 million was made on December 30, 2011. In January 2012, 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 2012. The first quarterly dividend payment of approximately $1.4 million was made on March 30, 2012 and the second quarterly dividend of

$1.4 million was paid on June 29, 2012, with subsequent quarterly payments to be approximately the same amount. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the Company's stockholders.

Use of Estimates

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

Components of the Company's Condensed Consolidated Balance Sheet

Accounts Receivable (in thousands):

	June 30, 2012	December 31, 2011
Accounts receivable trade	$ 41,172	$ 27,972
Accrued ship and debit and rebate claims	(22,949)	(18,361)
Allowance for doubtful accounts	(257)	(215)
Total	$ 17,966	$ 9,396

Prepaid Expenses and Other Current Assets (in thousands):

	June 30, 2012	December 31, 2011
Prepaid legal fees	$ 1,750	$ 3,500
Prepaid income tax	659	118
Prepaid maintenance agreements	317	669
Interest receivable	495	625
Other receivables	1,310	—
Supplier prepayment	1,400	—
Other	1,827	2,156
Total	$ 7,758	$ 7,068

Other Assets (in thousands):

	June 30, 2012	December 31, 2011
Prepaid royalty - SemiSouth (Note 15)	$ 10,000	$ 10,000
Investment in SemiSouth (Note 15)	7,000	7,000
Note receivable, net of interest discount - SemiSouth (Note 15)	12,678	—
Financing lease receivables and deposits - SemiSouth (Note 16)	6,613	7,558
SemiSouth purchase option (Note 15)	6,216	—
Other	873	1,953
Total	$ 43,380	$ 26,511

3. STOCK PLANS AND SHARE-BASED COMPENSATION:

Stock Plans

As of June 30, 2012 , the Company had two stock-based compensation plans (the “Plans”) which are described below.

2007 Equity Incentive Plan

The 2007 Equity Incentive Plan (the "2007 Plan") was adopted by the board of directors on September 10, 2007 and approved by the stockholders on November 7, 2007 as an amendment and restatement of the 1997 Stock Option Plan (the "1997 Plan"). The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards ("RSUs"), stock appreciation rights, performance stock awards and other stock awards to employees, directors and consultants. In June 2012, the Company's stockholders approved the 2007 Equity Incentive Plan, as amended to increase the aggregate number of shares of the Company's common stock authorized for issuance under the plan by 2,800,000 shares. As of June 30, 2012 , the maximum remaining number of shares that may be issued under the 2007 Plan was 8,730,621 shares, which includes options issued but not exercised and awards granted but unvested and 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, until June 2012, provided in certain circumstances (depending on the status of the particular director's holdings of Company stock options) for the automatic annual 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 the following initial grants under the 2007 Plan: (a) on the first trading day of the month following commencement of service, an option to purchase the number of shares of common stock equal to: the fraction of a year between the date of the director's appointment to the board of directors and the next July 1, multiplied by 8,000 , which option shall vest on the next July 1 st ; 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. In July 2012, this program was amended by eliminating the grants described above in their entirety, and providing for grants to outside directors as follows: effective annually, upon the first trading day of July, each outside director would receive a grant of an equity award with an aggregate value of $100,000 . At each outside directors election, such award would consist entirely of RSUs or entirely of stock options. The quantity of options would be calculated by dividing $100,000 by the Black-Scholes value on the date of grant. The quantity of RSUs issued would be calculated by dividing $100,000 by the grant date fair value. Further, on the date of election of a new outside director, such new director would receive such grant as continuing outside directors receive on the first trading day of July; provided, however, that such grant is prorated for the portion of the year that such new outside director will serve until the next first trading day of July. 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 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the “Purchase Plan”), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee's compensation, to the purchase of shares of the Company's common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company's common stock on the first day of each offering period, or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock were reserved for issuance to employees under the Purchase Plan. As of June 30, 2012 , 2,412,036 shares had been purchased and 587,964 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 expense to recognize. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award.

Determining Fair Value of Stock Options

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

Expected Volatility . The Company calculates expected volatility based on the historical price volatility of the Company's stock.

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

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

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

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

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three and six months ended June 30, 2012 and June 30, 2011 (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Cost of revenues	$ 256	$ 216	$ 501	$ 455
Research and development	1,566	980	2,687	1,791
Sales and marketing	746	543	1,493	1,210
General and administrative	1,074	705	1,992	1,492
Total stock-based compensation expense	$ 3,642	$ 2,444	$ 6,673	$ 4,948

The following table summarizes total compensation expense related to unvested awards not yet recognized, net of expected forfeitures, and the weighted average period over which it is expected to be recognized as of June 30, 2012 .

	June 30, 2012	
	Unrecognized Compensation Expense for Unvested Awards	Weighted Average Remaining Recognition Period
	(In thousands)	(In years)
Options	$ 5,406	2.09
Performance-based awards	$ 1,705	0.50
Restricted stock units	$ 18,964	2.95
Purchase plan	$ 100	0.50

Stock compensation expense in the three and six months ended June 30, 2012 was $3.6 million (comprising approximately $0.9 million related to stock options, $0.7 million related to performance shares, $1.7 million related to restricted stock units and $0.3 million related to the Purchase Plan) and $6.7 million (comprising approximately $1.9 million related to stock options, $1.1 million related to performance shares, $3.1 million related to restricted stock units and $0.6 million related to the Purchase Plan), respectively.

Stock compensation expense in the three and six months ended June 30, 2011 was $2.4 million (comprising approximately $0.9 million related to stock options, $0.3 million related to performance shares, $0.9 million related to restricted stock units, $0.2 million related to the Purchase Plan and $0.1 million in compensation expense amortized from beginning inventory) and $4.9 million (comprising approximately $2.1 million related to stock options, $0.7 million related to performance shares, $1.4 million related to restricted stock units, $0.6 million related to the Purchase Plan and $0.1 million in compensation expense amortized from beginning inventory), respectively.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Risk-free interest rates	1.01%	2.20%	1.01%	2.20%
Expected volatility rates	45%	44%	45%	44%
Expected dividend yield	0.51%	0.54%	0.51%	0.54%
Expected term of stock options (in years)	6.4	6.0	6.4	6.0
Weighted-average grant date fair value of options granted	$ 18.31	$ 15.71	$ 18.31	$ 15.71

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

	*Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Risk-free interest rates	—%	—%	0.09%	0.17%
Expected volatility rates	—%	—%	48%	37%
Expected dividend yield	—%	—%	0.54%	0.51%
Expected term of purchase right (in years)	—	—	0.50	0.50
Weighted-average estimated fair value of purchase rights	$—	$—	$10.42	$9.40

*There were no employee stock purchase rights granted in the three months ended June 30, 2012 and 2011.

A summary of stock option activity under the Plans, excluding performance-based shares and restricted stock units, as of June 30, 2012 , and changes during the six months then ended, is presented below:

	Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	3,557	$ 24.01		
Granted	129	42.88		
Exercised	(584)	20.49		
Forfeited or expired	(3)	21.09		
Outstanding at June 30, 2012	3,099	$ 25.46	4.59	$ 37,602
Exercisable at June 30, 2012	2,576	$ 23.82	3.83	$ 34,766
Vested and expected to vest at June 30, 2012	3,073	$ 25.34	4.55	$ 37,575

The total intrinsic value of options exercised during the three and six months ended June 30, 2012 was $7.6 million and $11.5 million , respectively, and the intrinsic value of options exercised during the three and six months ended June 30, 2011 was $5.4 million and $11.6 million , respectively.

Performance-based Awards

Under the performance-based awards program, the Company grants awards in the first half of the performance year in an amount equal to twice the target number of shares to be issued if the target performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the targeted number depending on the Company's performance. The performance metrics of this program are annual targets consisting of net revenue, non-GAAP operating earnings and strategic goals. 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 six months ended June 30, 2012 , the Company issued approximately 102,000 performance-based awards to employees and executives. As the net revenue and non-GAAP operating earnings are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, are recorded throughout the year depending on the number of shares expected to be earned based on progress toward the performance targets. The cost of performance-based awards is determined using the fair value of the Company's common stock on the grant date, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

A summary of performance-based awards outstanding as of June 30, 2012 , and activity during the six months then ended, is presented below:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	—	$ —		
Granted	102	37.60		
Vested	—	—		
Forfeited or expired	—	—		
Outstanding at June 30, 2012	102	$ 37.60	0.5	$ 3,797
Outstanding and expected to vest at June 30, 2012	79		0.5	$ 2,986

The weighted-average grant-date fair value per share of performance-based awards granted in the three and six months ended June 30, 2012 was approximately $42.68 and $37.60 , respectively. The weighted-average grant-date fair value per share of performance-based awards granted in the six months ended June 30, 2011 was approximately $36.90 . There were no performance-based awards granted in the second quarter of 2011. The grant date fair value of awards released, which were fully vested, in the six months ended June 30, 2011 was approximately $3.0 million . There were no performance-based awards released in the three months ended June 30, 2011 , or in the three or six months ended June 30, 2012 , as the performance-based awards granted in 2011 and expected to vest in 2012 were canceled without vesting.

Restricted Stock Units (RSUs)

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

A summary of RSUs outstanding as of June 30, 2012 , and changes during the six months then ended, is as follows:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	458	$ 36.08		
Granted	261	41.88		
Vested	(106)	36.41		
Forfeited or expired	(9)	36.72		
Outstanding at June 30, 2012	604	$ 38.52	1.86	$ 22,541
Outstanding and expected to vest at June 30, 2012	553		1.84	$ 20,630

The weighted-average grant-date fair value per share of RSUs awarded in the three and six months ended June 30, 2012 was approximately $41.97 and $41.88 , respectively, and was approximately $36.24 and $36.33 , in the three and six months ended June 30, 2011 , respectively.

The grant date fair value of RSUs vested in the three and six months ended June 30, 2012 was approximately $3.7 million and $3.8 million , respectively, and was approximately $1.9 million and $2.0 million , in the three and six months ended June 30, 2011 , respectively.

4. FAIR VALUE MEASUREMENTS:

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

The Company's cash and investment instruments are classified within Level 1 or Level 2 of the fair-value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The type of instrument valued based on quoted market prices in active markets primarily includes money market securities. This type of instrument is generally classified within Level 1 of the fair-value hierarchy. The types of instruments valued based on other observable inputs (Level 2 of the fair-value hierarchy) include investment-grade corporate bonds and government, state, municipal and provincial obligations. Such types of investments are valued by using a multi-dimensional relational model, the inputs 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. In the first quarter of 2012, the Company changed its investment policy to allow the sale of long-term and short-term marketable securities prior to their stated maturity date. The Company principally holds securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, the funding of acquisitions and other strategic investments. As a result of this change in policy the Company classified its investment portfolio as available-for-sale as opposed to held-to-maturity as of March 31, 2012. The Company's investments classified as Level 1 and Level 2 are available-for-sale investments, and were recorded at fair market value.

The fair value hierarchy of the Company's marketable securities at June 30, 2012 and December 31, 2011 , was as follows (in thousands):

		Fair Value Measurement at June 30, 2012	
Description	**June 30, 2012**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**
Money market funds	$ 8,908	$ 8,908	$ —
Certificates of deposit	10,000	—	10,000
Corporate securities	50,068	—	50,068
Total	$ 68,976	$ 8,908	$ 60,068

		Fair Value Measurement at December 31, 2011	
Description	**December 31, 2011**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**
Commercial paper	$ 9,849	$ —	$ 9,849
Money market funds	30,190	30,190	—
Certificates of deposit	10,000	—	10,000
Corporate securities	62,940	—	62,940
Total	$ 112,979	$ 30,190	$ 82,789

The Company did not transfer any investments between Level 1, Level 2 or Level 3 of the fair-value hierarchy in the six months ended June 30, 2012 and the twelve months ended December 31, 2011.

On October 22, 2010, the Company entered into an agreement with SemiSouth Laboratories, as amended, pursuant to which the Company may be obligated to acquire SemiSouth if SemiSouth meets certain financial performance conditions on or before December 31, 2013. At June 30, 2012 , the Company determined the fair value of this potential obligation to be zero. The Company developed its own assumptions using Level 2 inputs in its fair-market valuation using a market approach valuation technique to determine the fair value of this obligation. The Company updates the estimated fair value of this potential obligation quarterly. Any changes are recorded in its unaudited condensed consolidated statements of income. In March 2012, in consideration for the loan agreement discussed below, the Company entered into an amended agreement with SemiSouth which established a maximum purchase price related to both the Company's option to acquire SemiSouth ("Purchase Option") and its potential obligation to acquire SemiSouth (as discussed above). The Company used Level 3 inputs in its fair-market valuation utilizing the income-approach valuation technique. The Company prepared a discounted cash flow analysis using the following unobservable inputs: weighted average cost of capital, long-term revenue growth, control premium, and discount for lack of marketability. The Company then used the Black-Scholes option pricing model to determine the fair value of the Company's purchase option to be approximately $6.2 million . The Company's valuation technique derived inputs principally from comparable company market data (i.e., correlation values). The Company considers this to be a Level 3 investment as there was no specific market data for this instrument or similar instruments. The Company has not elected the fair value option for this purchase option, under ASC 825. See Note 15, *Investment in Third Party* , below for further details on the valuation method used.

In March 2012 the Company loaned SemiSouth $18.0 million , and in exchange the Company was issued a promissory note and received the modification discussed above to establish a maximum price under the Purchase Option. The note has been classified as Level 3 in the fair-value hierarchy, as there was no market data for this instrument. The estimated fair value of the note was approximately $12.7 million at June 30, 2012 , consisting of the promissory note of $18.0 million , net of the of the unamortized interest discount related to the $6.2 million purchase option (of which $0.9 million was amortized as of June 30, 2012) (see Note 15, *Investment in Third Party* , below for further details on the SemiSouth loan). The fair value was estimated by calculating the present value of cash flows using a market discount rate for similar investments. The Company intends to hold the note to maturity, which occurs in March 2014. The following table presents the changes in Level 3 investments for the six months ended June 30, 2012 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs (Level 3)
	Note Receivable
Beginning balance at January 1, 2012	$ —
Purchases and issuances	12,678
Change in fair value	—
Settlements	—
Ending balance at June 30, 2012	$ 12,678

5. INVENTORIES:

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

	June 30, 2012	December 31, 2011
Raw materials	$ 8,914	$ 12,389
Work-in-process	13,790	7,841
Finished goods	25,851	31,780
Total	$ 48,555	$ 52,010

6. GOODWILL AND INTANGIBLE ASSETS:

Changes in the carrying amount of goodwill during the six months ended June 30, 2012 are as follows (in thousands):

	Six Months Ended June 30, 2012
Balance at January 1, 2012	$ 14,786
Goodwill acquired during the period	62,568
Goodwill adjustments	—
Ending balance at June 30, 2012	$ 77,354

The $62.6 million of goodwill acquired in 2012 resulted from the purchase of Concept (see Note 14, *Acquisition* , for further details).

Intangible assets consist primarily of developed technology, acquired licenses, customer relationships, trade name, in-process research and development and patent rights, and are reported net of accumulated amortization. In May 2012, the Company acquired Concept, resulting in the addition of the following intangible assets; developed technology of $23.8 million , which will be amortized over a period of approximately 4 to 12 years; customer relationships of $16.7 million , which will be amortized over a period of 10-years; and tradename (Concept) of $3.6 million , which will be amortized over a period of 2 years. The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the acquired license or patent rights, which range from 5 to 12 years, with the exception of $4.7 million of in-process research and development which will be amortized once the development is completed and products are available for sale. The Company does not expect the amortization for its in-process research and development to begin in 2012 . Amortization for acquired intangible assets was approximately $1.3 million and $1.5 million in the three and six months ended June 30, 2012 and $0.3 million and $0.5 million in the three and six months ended June 30, 2011 , respectively. The Company does not believe there is any significant residual value associated with the following intangible assets:

	June 30, 2012			December 31, 2011		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(in thousands)					
In-process research and development	$ 4,690	$ —	$ 4,690	$ 4,690	$ —	$ 4,690
Technology licenses	3,000	(1,875)	1,125	3,000	(1,725)	1,275
Patent rights	1,949	(1,949)	—	1,949	(1,949)	—
Developed technology	26,670	(1,373)	25,297	2,920	(829)	2,091
Customer relationships	17,610	(600)	17,010	910	(114)	796
Tradename	3,600	(300)	3,300	—	—	—
Other intangibles	37	(37)	—	37	(37)	—
Total intangible assets	$ 57,556	$ (6,134)	$ 51,422	$ 13,506	$ (4,654)	$ 8,852

The estimated future amortization expense related to intangible assets at June 30, 2012 is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2012 (remaining 6 months)	$ 3,683
2013	7,405
2014	6,072
2015	5,009
2016	4,394
Thereafter	20,169
Total (1)	$ 46,732

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

7. SIGNIFICANT CUSTOMERS AND EXPORT SALES:

Segment Reporting

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

Customer Concentration

Ten customers accounted for approximately 64% and 65% of net revenues for the three and six months ended June 30, 2012 and 66% in both the three and six months ended June 30, 2011 . A significant portion of these revenues are attributable to sales of the Company’s products to distributors of electronic components. These distributors sell the Company’s products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
Customer	**2012**	**2011**	**2012**	**2011**
A	21%	19%	21%	19%
B	12%	14%	12%	13%

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

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments, trade receivables, the Company's note from SemiSouth and the Company's lease line of credit to SemiSouth. The Company has cash investment policies that limit cash investments to low-risk investments. With respect to the Company's agreements with SemiSouth, the Company monitors SemiSouth's credit quality on an ongoing basis. If the credit worthiness of SemiSouth diminishes, the Company will establish a specific reserve against the lease line receivable and / or note receivable. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit exposure related to its customers. As of June 30, 2012 and December 31, 2011 , 75% and 79% , respectively, of accounts receivable were concentrated with the Company's top 10 customers.

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

Customer	**June 30, 2012**	**December 31, 2011**
A	29%	36%
B	19%	10%

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

International Sales

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Hong Kong/China	44%	38%	44%	36%
Taiwan	17%	23%	17%	23%
Korea	12%	15%	13%	16%
Western Europe (excluding Germany)	10%	9%	10%	10%
Japan	6%	6%	6%	6%
Singapore	2%	2%	2%	2%
Germany	1%	1%	1%	1%
Other	2%	1%	2%	1%
Total foreign revenue	94%	95%	95%	95%

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

Product Sales

Revenue mix by end market for the three and six months ended June 30, 2012 and 2011 was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
End Market	2012	2011	2012	2011
Consumer	36%	36%	38%	36%
Communications	24%	28%	25%	30%
Industrial	28%	23%	25%	22%
Computer	12%	13%	12%	12%

8. EARNINGS PER SHARE:

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Basic earnings per share:				
Net income (loss)	$ (7,176)	$ 10,599	$ 285	$ 20,453
Weighted-average common shares	28,619	28,938	28,423	28,784
Basic earnings (loss) per share	$ (0.25)	$ 0.37	$ 0.01	$ 0.71
Diluted earnings per share (1):				
Net income (loss)	$ (7,176)	$ 10,599	$ 285	$ 20,453
Weighted-average common shares	28,619	28,938	28,423	28,784
Effect of dilutive securities:				
Employee stock plans	—	1,408	1,201	1,487
Diluted weighted-average common shares	28,619	30,346	29,624	30,271
Diluted earnings (loss) per share	$ (0.25)	$ 0.35	$ 0.01	$ 0.68

(1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share when they become contingently issuable per ASC 260-10, *Earnings per Share* and excludes such shares when they are not contingently issuable. The Company has excluded all performance-based awards underlying the fiscal 2012 and 2011 awards as those shares were not contingently issuable as of the end of the periods reported.

In the three months ended June 30, 2012 all shares attributable to stock-based awards were excluded in the computation of diluted earnings per share, as the Company was in a net loss position. Approximately 306,586 shares in the six months ended June 30, 2012, and 262,533 shares and 234,700 shares for the three and six months ended June 30, 2011 , respectively, were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive.

9. PROVISION FOR INCOME TAXES:

In the quarter ended June 30, 2012, the Company reached an understanding regarding the terms for settling with the U.S. Internal Revenue Service ("IRS") and closed out all positions as part of the examination of the Company's income tax returns for the years 2003 through 2006 . On August 2, 2012, the IRS signed a formal closing agreement with the Company that is consistent with the intentions of the parties pursuant to their earlier understanding. As a result, the Company remeasured its tax positions based on the facts, circumstances, and information available at the reporting date.

During the third quarter of 2012 the Company will make a one-time payment of taxes and interest totaling $42.6 million . The provision for income tax in the second quarter of 2012 included a one-time charge of $44.8 million , comprising $35.0 million in federal income taxes, net interest of $5.7 million , and state income taxes (including interest) of approximately $4.1 million . The impact of the charge was partially offset by the reversal of $26.9 million of related unrecognized tax benefits that had been recorded as non-current liabilities in the Company's consolidated balance sheets, and by a $2.2 million reduction of the valuation allowance on the Company's California deferred tax assets, resulting in a net charge of $15.7 million . Reflecting the net impact of the charge, the Company's effective tax rates for the three- and six-month periods ended June 30, 2012 were 174.7% and 98.5% respectively, compared with 22.3% and 20.6% for the corresponding periods in 2011. (The effective tax rates for the periods ended June 30, 2011 were lower than the federal statutory rate of 35% due primarily to the geographic distribution of the Company's world-wide earnings and the beneficial impact of the research and experimentation tax credit.) Further, the agreement confirms that the royalty arrangement between the Company and its foreign subsidiary will end on October 31, 2012, resulting in a substantially lower effective tax rate for the Company in future periods.

The amount of liabilities for unrecognized tax benefits (net of the federal benefit on state issues) that, if recognized, would favorably affect the effective income-tax rate in any future period are $10.1 million and $34.9 million at June 30, 2012 and January 1, 2012, respectively. The primary component of the net change is the $26.8 million realization of unrecognized tax benefits due to the agreement described above. The Company's continuing practice is to recognize interest and/or penalties related to income-tax matters in income-tax expense. The Company's unrecognized tax benefit liabilities include interest and penalties at

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012 and January 1, 2012 of $0.5 million and $4.4 million , respectively, which were recorded in long-term income taxes payable in the accompanying Condensed Consolidated Balance Sheets. Changes in the Company's unrecognized tax benefits over the next twelve months cannot be reasonably estimated at this time.

The Company has concluded all U.S. federal income tax matters for the years through 2006, and the royalty issue for all tax years after 2003. The fiscal years 2007 through 2009 are also under audit by the IRS.

The Company accounts for income taxes under the provisions of ASC 740. Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur.

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 June 30, 2012 , the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets as the Company does not believe that it is 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.

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

10. INDEMNIFICATIONS:

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

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of June 30, 2012 . For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

11. COMMITMENTS:

Supplier Agreements

The Company purchases wafers through purchase orders from its foundries. All but one of the Company's wafer agreements were executed in U.S. currency. Until June 2011, this one foundry required wafer purchases to be in Japanese yen; however, the purchase price within this agreement was fixed at a base rate and allowed for some sharing of the impact of exchange rate fluctuations from the base rate. The currency fluctuation experienced between the time invoices were submitted to the Company until the time the yen was purchased and remitted to the supplier was a financial responsibility of the Company. The Company accounted for the gain or loss related to the payment of these transactions as part of other income or expense. The Company has renegotiated its supply agreement with this foundry to purchase wafers in U.S. currency.

Two of the Company's major suppliers have wafer supply agreements based in U.S. dollars; however, the agreements with these foundries also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, the Company's management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between the Company and each of these suppliers.

12. LEGAL PROCEEDINGS AND CONTINGENCIES:

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

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $34.0 million in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages award. Fairchild also raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys' fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to $6.1 million , granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys' fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent injunction for 90 days to permit Fairchild to petition the Federal Circuit Court of Appeals for a further stay. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December 2008. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement, and the parties completed post-trial briefing on the issue of willfulness shortly thereafter. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents. The Court also invited briefing on enhanced damages and attorneys' fees, and Fairchild filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of $12.9 million . Fairchild filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company filed a cross-appeal seeking to increase the damages award. Briefing on the appeal is complete, and the appeal was argued on January 11, 2012. A ruling is expected later this year.

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 in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On February 10, 2011, the Court issued an order maintaining the stay with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case pending the appeal in that case. On April 18, 2011, the Court rescheduled the trial to begin in January 2012, and on June 2, 2011 the

Court moved the trial date to permit the parties to address another patent the Company has accused Fairchild of infringing. Following a trial in April 2012, the jury returned a verdict finding that Fairchild infringes two of the Company's patents, that Fairchild has induced others to infringe the Company's patents, and also upheld the validity of the infringed patents. Of the two remaining counterclaim patents Fairchild asserted in the case, one was found not to be infringed, but the jury found the second patent to be infringed by a limited number of the Company's products, although the jury further found the Company did not induce infringement by any customers, including customers outside the United States. The Company is challenging the validity and enforceability of that patent in post-trial proceedings, issues to be decided by the judge overseeing the case. Nevertheless, the Company estimates that even if the verdict on Fairchild's patent were ultimately upheld, the sales potentially impacted would amount to only about 0.1% of the Company's revenues. The Company will also seek an injunction preventing further infringement of its own patents and is seeking financial damages, as well as enhanced damages for willful infringement, issues to be decided in separate proceedings at a later date.

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against SG Corporation, a Taiwanese company, and its U.S. subsidiary. The Company's complaint alleged that certain integrated circuits produced by SG infringed and continue to infringe certain of its patents. On June 10, 2005, in response to the initiation of the International Trade Commission (ITC) investigation discussed above, the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay and scheduled a case management conference. On December 6, 2006, SG filed a notice of appeal of the ITC decision as discussed above. In response, and by agreement of the parties, the District Court vacated the scheduled case management conference and renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination. On November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects, and SG did not file a petition for review. The parties subsequently filed a motion to dismiss the District Court case without prejudice. On November 4, 2009, the Company re-filed its complaint for patent infringement against SG and its parent corporations, Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation, to address their continued infringement of patents at issue in the original suit that recently emerged from SG requested reexamination proceedings before the U.S. Patent and Trademark Office (USPTO). The Company seeks, among other things, an order enjoining Fairchild and SG from infringing the Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that one of the two patents now at issue in the case is unenforceable. On May 5, 2010, Fairchild and SG filed an amended answer including counterclaims accusing the Company of infringing two patents; the Company contests these new claims vigorously, and since that time Fairchild has withdrawn its claim for infringement of one of the patents it asserted against the Company, leaving just one Fairchild patent in the case. The Court held a claim construction hearing on March 24, 2011 and issued a first claim construction order regarding the Company's asserted patents on July 13, 2011 and a second claim construction order regarding Fairchild's asserted patent on August 30, 2011. Discovery is currently under way.

In February 2010, Fairchild and System General (“SG”) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The suits assert four Chinese patents and seek an injunction and damages of approximately $19.0 million . Power Integrations Netherlands 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. Early this January, the Company received rulings from the PRB invalidating the majority of the claims Fairchild asserted in litigation. The Suzhou Court conducted evidentiary hearings in May and July of 2012, but the court has not set a schedule for further proceedings at this time. The Company believes the Fairchild and SG claims discussed above are without merit and intends to contest them vigorously.

On July 11, 2011, the Company filed a complaint in the U.S. District Court, District of Columbia, against David Kappos in his capacity as Director of the United States Patent and Trademark Office (“PTO”) as part of the ongoing reexamination proceedings related to one of the patents asserted against Fairchild and SG in the Delaware litigation described above. The Company filed a motion for summary judgment on a preliminary jurisdictional issue, and the PTO filed a cross-motion to dismiss on this same issue; briefing on these motions is now complete, with a ruling expected in the coming months. No schedule has been set for the case.

On May 1, 2012, Fairchild Semiconductor Corporation and Fairchild's wholly-owned subsidiary, System General Corporation (referred to collectively as “Fairchild”), filed a complaint against the Company in the United States District Court for the District of Delaware. In its complaint, Fairchild alleges that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company has answered Fairchild's complaint, 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, and the Company has also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild has filed a motion to dismiss the Company's counterclaims, which the Company opposes. No case schedule has been set at this time.

The Company is unable to predict the outcome of legal proceedings with certainty, and there can be no assurance that Power Integrations will prevail in the above-mentioned unsettled litigations. These litigations, whether or not determined in Power Integrations' favor or settled, will be costly and will divert the efforts and attention of the Company's management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. Currently, the Company is not able to estimate a loss or a range of loss for the ongoing litigation disclosed above, however adverse determinations in litigation could result in monetary losses, the loss of proprietary rights, subject the Company to significant liabilities, require Power Integrations to seek licenses from third parties or prevent the Company from licensing the technology, any of which could have a material adverse effect on the Company's business, financial condition and operating results.

In the quarter ended March 31, 2011, the IRS issued the Company a notice of proposed adjustment proposing material adjustments to the Company's taxable income for the years 2003 through 2006 related to the Company's intercompany research and development cost-sharing arrangement and related issues and in December 2011, the Company received an addendum to the notice of proposed adjustments from the IRS related to the Company's intercompany research and development cost sharing arrangement. In the quarter ended June 30, 2012, the Company reached an understanding regarding the items for settling with the IRS and closed out all positions as part of the examination of the Company's income tax returns for the years 2003 through 2006. On August 2, 2012, the IRS signed a formal closing agreement with the Company that is consistent with the intentions of the parties pursuant to their earlier understanding. As a result, the Company remeasured its tax positions based on the facts, circumstances, and information available at the reporting date. The resolution of the 2003-2006 audit resulted in a tax assessment to the Company of $35.5 million and interest of $8.7 million . Additionally, as a result of the agreement, the Company will incur state income taxes and interest of approximately $0.3 million . Even though the Company believes the IRS's position with respect to the adjustments is inconsistent with applicable tax law, and that the Company has a meritorious defense to its position, the Company elected to accept a negotiated agreement that it believes to be in the best interests of the Company's stockholders. The agreement addresses the royalty issue relating to the Company's international tax structure for all tax years after 2003 (including the years 2007 - 2009, which are currently being audited by the IRS). Further, the agreement confirms that the royalty arrangement between the Company and its foreign subsidiary will end on October 31, 2012, resulting in a substantially lower effective tax rate for the Company in future periods. Also, the agreement will allow the Company to repatriate up to $101.9 million from its foreign-based subsidiary in future periods without incurring U.S. income taxes.

13. RECENT ACCOUNTING PRONOUNCEMENTS:

On January 1, 2012, the Company adopted the following accounting pronouncements:

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement,* ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The Company adopted these amendments in the first quarter of fiscal 2012.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (* ASC Topic 220). This amendment gives an entity two options to present the total of comprehensive income, the components of net income, and the components of other comprehensive income. An entity can elect to present comprehensive income in either (1) a single continuous statement of comprehensive income, or (2) in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The Company adopted this amendment beginning in the first quarter of 2012.

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

14. ACQUISITION:

On May 1, 2012, the Company, through its subsidiaries Power Integrations Netherlands B.V., a Dutch company, and Power Integrations Limited, a Cayman Islands company, completed the acquisition of CT Concept Technologie AG ("Concept" or "Concept Group"), a Swiss company, by acquiring all of the outstanding shares of its Swiss parent companies Concept Beteiligungen AG and CT-Concept Holding AG (the “Acquisition”), pursuant to the Share Purchase Agreement ("Purchase Agreement") described in the Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on April 5, 2012.

The acquisition has been accounted for using the acquisition method of accounting in accordance with Accounting Standards Codification (“ASC”) 805 - Business Combinations. Under the acquisition method of accounting, the total purchase consideration of the acquisition is allocated to the tangible assets and identifiable intangible assets and liabilities assumed based on their relative fair values. The excess of the purchase consideration over the net tangible and identifiable intangible assets is recorded as goodwill, and was derived from expected benefits from technology, cost synergies and knowledgeable and experienced workforce who joined the Company after the acquisition. Goodwill is not expected to be deductible for tax purposes. The purchase price allocation is preliminary since the valuation of the net tangible and identifiable intangible assets is still being finalized. Of the total purchase price of $130.7 million (including cash assumed), $128.3 million was used to fund the acquisition in the second quarter of 2012. Pursuant to the purchase agreement, the purchase price is subject to a net asset value adjustment which is estimated to be approximately $2.4 million . The net asset value adjustment will be paid within approximately six months after May 1, 2012.

The acquisition furthers the Company's strategic aim to offer highly integrated high-voltage power-conversion products across the widest possible range of power levels and applications. While Power Integrations has historically focused on power supplies up to 500 watts of output, Concept products address higher-power applications, such as industrial motors and renewable energy systems. As such, the combination is complementary to Power Integrations' existing business. Furthermore, Concept also has an expanding addressable market and a growing, profitable revenue stream that are consistent with Power Integrations' financial goals/targets.

The following table summarizes the purchase price and estimated fair values of the assets acquired and the liabilities assumed as of May 1, 2012, the completion of the acquisition of Concept ("Closing Date").

		Total Amount
Assets Acquired		(in thousands)
Cash	$	14,933
Accounts receivable		3,220
Inventories		10,631
Prepaid expenses and other current assets		2,777
Property and equipment, net		3,363
Intangible assets:		
Developed technology		23,750
Tradename		3,600
Customer relationships		16,700
Goodwill		62,567
Total assets acquired		141,541
Liabilities assumed		
Current liabilities		4,587
Deferred tax liabilities		5,667
Other liabilities		634
Total liabilities assumed		10,888
Total purchase price	$	130,653

The fair value of intangible assets of $44.1 million has been allocated to the following three asset categories: 1) developed technology, 2) tradename and 3) customer relationships. The first two will be amortized on a straight line basis over the estimated useful life of the assets. The third intangible asset, customer relationships, will be amortized on an accelerated basis over the estimated life of the asset. The following table represents details of the purchased intangible assets as part of the acquisition:

		Fair Value Amount	Estimated Useful Life
		(in thousands)	(in years)
Developed technology	$	23,750	4 - 12
Tradename		3,600	2
Customer relationships		16,700	10
Total Concept intangibles	$	44,050	

The fair value of the identifiable intangible assets: developed technology, trademark and customer relationships were determined based on the following approach.

Developed Technology: The value assigned to the acquired developed technology was determined using the income approach. The royalty savings were estimated by applying an estimated royalty rate to the projected revenues for Concept for each developed technology. The selected royalty rate for the developed technology was based on the Company's analysis of comparable technology, royalty rate indications, and licensing agreements for comparable technologies. The royalty savings were then adjusted for taxes and discounted to present value. The fair value of developed technology was capitalized as of the acquisition date and will be amortized using a straight-line method to cost of revenues over the estimated remaining life of 4 - 12 years.

Tradename: The value assigned to Concept's tradename was determined using the income approach. The present value of the expected after-tax royalty savings was added to the sum of the expected amortization tax benefit. The royalty rate was selected based on an analysis of comparable tradename agreements. In addition, the rate was adjusted based on an analysis of

Concept's projected performance and the importance of the tradename to the industry. The selected royalty rate was then applied to the projected revenues for the tradename. The fair value of the tradename was capitalized as of the acquisition date and will be amortized using a straight-line method to sales and marketing expenses over the estimated period of use of 2 years.

Customer Relationships: An intangible customer relationship asset was recognized to the extent that the Company was expected to benefit from future revenues reasonably anticipated given the history and operating practices of Concept. The value assigned to customer relationships was determined using the income approach. Forecasted cash flows derived from the acquired customer relationships, net of returns on contributory assets, were discounted to present value. Expectations related to future customer retention were based on historical data and a long-term forecast that was constructed based on the Company's financial projections and expectations. The associated income taxes were based on an assumed tax rate of a hypothetical buyer. The net income was then charged for the required returns of debt-free working capital, net fixed and other assets, developed technology and tradename to derive the residual cash flows related to the customer relationships acquired. The residual cash flows were then discounted to present value. The fair value of customer relationships was capitalized as of the acquisition date and will be amortized on an accelerated basis to sales and marketing expenses over the estimated remaining life of 10 years.

Pro Forma Information

From May 1, 2012 to June 30, 2012 Concept revenues of $4.6 million were included in the Company's condensed consolidated statements of operations , and is included in the pro forma information below to provide supplemental comparable information. The loss of Concept for the same period of approximately $1.0 million was included in the Company's condensed consolidated statements operations , which includes intangible amortization and amortization of inventory markup. The loss from Concept is estimated because the Company is in the process of integrating Concept's operations and the Company does not maintain product line statements of operations .

For the purpose of the summary unaudited pro forma combined supplemental information, the acquisition was assumed to have occurred as of January 1, 2011. The pro forma combined supplemental information reflects the currency translation from Swiss francs to US dollars for the Concept historical financial statements. The pro forma information for January 1, 2011 to April 30, 2012, has been calculated after applying the Company's accounting policies and adjusting the results of Concept to reflect the additional amortization of intangible assets, and additional cost of revenues related to the inventory markup that would have been charged assuming the fair value adjustments had been incurred as of January 1, 2011. The unaudited pro forma combined financial information is for informational purposes only and does not purport to represent what the Company's actual results would have been if the acquisition had been completed as of the date indicated above, or that may be achieved in the future. The unaudited pro forma combined supplemental information does not include the effects of any cost savings from operating efficiencies or synergies that may result from the acquisition (in thousands, except per share amounts).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenues	$ 79,004	$ 88,253	$ 157,268	$ 173,954
Net income (loss)	$ (6,895)	$ 9,616	$ 563	$ 18,373
Earnings (loss) per share - diluted	$ (0.24)	$ 0.32	$ 0.02	$ 0.61

15. INVESTMENT IN THIRD PARTY:

On October 22, 2010, the Company made a $7.0 million investment in preferred stock of a privately held company, SemiSouth Laboratories (“SemiSouth”). Also in October 2010, the Company paid $10.0 million as a prepaid royalty in exchange for the right to use SemiSouth's technology. The Company will amortize the royalty to cost of revenues based on the Company's sales of products incorporating the licensed technology. The Company classified its investment in SemiSouth, with a carrying value of $7.0 million and prepaid royalty of $10.0 million within Other Assets in the Company's condensed consolidated balance sheet as of June 30, 2012 . The Company does not expect to amortize the prepaid royalty in 2012.

In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the terms of the agreement, SemiSouth can borrow up to $8.6 million through January 2013, of which a total of $8.5 million had been funded as of June 30, 2012 . Refer to Note 16, *Lease Line to Third Party* , for details.

The Company included the lease line receivable and deposits on equipment in Other Assets and Prepaid Expenses and Other Current Assets in its consolidated balance sheet at June 30, 2012 .

The Company's 2010 agreement with SemiSouth provides, among other things, that the Company has the option to acquire SemiSouth in the future (“Call Option”) and that the Company may be obligated to acquire SemiSouth at a future date if SemiSouth achieves certain financial performance conditions (“Put Option”). The Put and Call Options terminate on the date that is approximately a month following delivery to the Company of SemiSouth's financial statements for the quarter ending December 31, 2013.

The Call Option can be exercised by the Company at a multiple of SemiSouth's annualized net operating profits after tax (“NOPAT”) (based on the average of this measure over a period of several months), as defined in the agreement. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth. The minimum acquisition price would be $36 million , subject to certain adjustments. Pursuant to an amended agreement entered into in March 2012, the maximum purchase price shall not exceed $80.0 million .

The Put Option can only be exercised by SemiSouth once certain revenue and profit metrics have been reached. At that time, SemiSouth could obligate the Company to acquire SemiSouth at a multiple of SemiSouth's NOPAT. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth limited to a maximum of $80.0 million pursuant to the March 2012 amendment. In order to reach the revenue and profit metrics required to exercise the Put Option, SemiSouth would need to increase its quarterly revenue to approximately 17 times the level of revenues achieved in the second quarter of 2012.

The NOPAT multiple was determined to reflect fair value based on the Market Approach using Level 2 inputs that are derived principally from observable market data by comparing multiples for similar publicly traded companies. Due to the fact that the strike price of the Put Option is continually being adjusted to reflect the changes in the fair value of SemiSouth, the fair value of the Put Option was determined to be zero .

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

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

In March 2012, the Company loaned SemiSouth $18.0 million , and in exchange the Company was issued a promissory note. In consideration for the loan the Company obtained an amendment to its 2010 agreement with SemiSouth to establish a maximum purchase price related to both the Company's option to acquire SemiSouth ("Purchase Option") and its potential obligation to acquire SemiSouth (as discussed above). The Company used Level 3 inputs in its fair-market valuation utilizing the income-approach valuation technique. The Company prepared a discounted cash flow analysis using the following unobservable inputs: weighted average cost of capital, long-term revenue growth, control premium, and discount for lack of marketability. The Company then used a Black-Scholes option pricing model to determine the fair value of the Company's purchase option to be approximately $6.2 million . The Company's valuation technique derived inputs principally from market data (i.e., correlation values). The Company accounted for the $18.0 million promissory note in the Other Assets caption in its condensed consolidated balance sheet, net of the $6.2 million interest discount related to the Purchase Option, of which $0.9 million was amortized as of June 30, 2012. The interest discount will be amortized to interest income over the life of the promissory note. The amortization of the interest income and the stated interest rate on the promissory note reflect the approximate fair value of the effective interest rate. The Company also recorded the corresponding $6.2 million value of the Purchase Option in Other Assets in its condensed consolidated balance sheet. The following table reflects the Company's interest income related to its SemiSouth agreements (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Interest income on note from SemiSouth	$ 90	$ —	$ 114	$ —
Non-cash interest income on note from SemiSouth	623	—	780	—
Interest income from SemiSouth lease line	83	21	164	60
Total interest income from SemiSouth	$ 796	$ 21	$ 1,058	$ 60

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

The Company has determined that its investment in SemiSouth, in which the Company holds less than 20% equity interest, is a variable interest entity ("VIE") in which the Company is not the primary beneficiary. The primary factors in the Company's assessment were; (i) SemiSouth's management team and board of directors were solely responsible for all business and financial decisions for SemiSouth and (ii) the Company does not have the ability to direct the activities that significantly impact the economic performance of SemiSouth. The Company accounts for its non-marketable investment in SemiSouth under the cost method.

The Company's maximum exposure to loss as a result of its interest in SemiSouth is limited to the aggregate of the carrying value of its equity investment, up to $8.6 million for the lease line agreement and $18.0 million for the loan to SemiSouth. There were no additional future funding commitments to SemiSouth as of June 30, 2012 .

16. LEASE LINE TO THIRD PARTY:

In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the term of the agreement, SemiSouth can borrow up to $8.6 million through January 2013. As of June 30, 2012 , a total of $8.5 million had been funded, consisting of: $8.2 million funded, less payments withheld under this lease arrangement to finance capital equipment commencing in February 2011; and $0.3 million paid as deposits on equipment which the Company will lease to SemiSouth upon delivery of such equipment. The Company included the lease line receivable and deposits on equipment in Other Assets and Prepaid Expenses and Other Current Assets in its condensed consolidated balance sheet at June 30, 2012 . The total lease payments related to the $8.2 million funded, including interest, will be received over a four-to-eight year term and are reflected in the table below (in millions):

Fiscal Year	Total Minimum Lease Payments
2012 (remaining 6 months)	$ 0.9
2013	1.2
2014	1.2
2015	1.2
2016	1.2
Thereafter	3.0
Total	$ 8.7

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

17. BANK LINE OF CREDIT:

In February 2011, the Company entered into an unsecured credit agreement with a bank (the "Credit Agreement"). Pursuant to the Credit Agreement, the Company could request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of $50.0 million . On April 2, 2012, the amount available under this credit agreement was increased to $65.0 million , the proceeds of which could be used for working capital requirements and other general corporate purposes.

On July 5, 2012, the Company terminated the Credit Agreement and entered into a new Credit Agreement (the "New Credit Agreement") with two banks. The New Credit Agreement provides the Company with a $100.0 million revolving line of credit to use for general corporate purposes with a $20 million sublimit for the issuance of standby and trade letters of credit. The Company's ability to borrow under the revolving line of credit is conditioned upon the Company's compliance with specified covenants, including reporting and financial covenants, primarily a modified current ratio and a debt to earnings ratio, with which the Company is currently in compliance. The New Credit Agreement terminates on July 5, 2015; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default.

In connection with entering into the New Credit Agreement, as of July 5, 2012, the Company's existing $15.0 million letter of credit under the Credit Agreement with a bank, was deemed to have been issued pursuant to and subject to the terms and conditions of the New Credit Agreement. As of July 5, 2012, no amounts were outstanding under the terminated facility. Refer to Note 15, *Investment in Third Party,* for details on the Company's outstanding letter of credit.

18. RETIREMENT PLANS:

In connection with the Company's acquisition of Concept in May 2012, the Company sponsors a defined benefit pension plan ("Pension Plan") in accordance with the legal requirements of Switzerland (refer to Note 14, *Acquisition* , for details on Concept). The plan assets, which provide benefits in the event of an employee's retirement, death or disability, are held in legally autonomous trustee-administered funds that are subject to Swiss law. Benefits are based on the employee's age, years of service and salary, and the plan is financed by contributions by both the employee and the Company.

The net periodic benefit cost of the Pension Plan was not material to the Company's financial statements during the three months ended June 30, 2012. The acquired projected benefit obligation of $5.1 million , net of plan assets of $4.5 million , was $0.6 million as of the Closing Date. The projected benefit obligation, net of plan assets, did not change from the closing date to June 30, 2012. The Company has recorded the unfunded amount as a liability in its Condensed Consolidated Balance Sheet at June 30, 2012, under the pension liability caption. The Company expects to make contributions to the Pension Plan of approximately $0.3 million during the current fiscal year.

In accordance with the Compensation-Retirement Benefits Topic of ASC 715-20, the Company will recognize the over-funded or under-funded status of its defined postretirement plan as an asset or liability in its statement of financial position. The company will measure the plan assets and benefit obligations as of the date of the fiscal year-end.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, and with consolidated financial statements and management's discussion and analysis of our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on February 29, 2012. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A-"Risk Factors" and elsewhere in this report.

Overview

We design, develop, and market analog and mixed-signal integrated circuits (ICs) and other electronic components used in high-voltage power conversion. Our products are used primarily in AC-DC power-supplies, with applications including mobile-device chargers, computers, home-entertainment equipment, appliances, electronic utility meters and LED lights. Since our May 2012 acquisition of CT-Concept Technologie AG (Concept), we also offer drivers - typically circuit boards containing multiple ICs, electrical isolation components and other circuitry - used to operate arrays of high-voltage, high-power transistors known as IGBT modules. These drivers and modules are used for power conversion in high-power applications such as industrial motors, solar and wind power systems, electric vehicles and high-voltage DC transmission systems.

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

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

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

- *Expand our addressable market to include a wider range of applications and power levels.* In recent years we have introduced IC products that enable us to bring the benefits of integration to power supplies requiring more than 50 watts of output, resulting in a significant expansion of our addressable market. These applications include main power supplies for flat-panel TVs and desktop PCs, as well as power supplies for LED streetlights, game consoles, and notebook computers, among others.

  In May 2012 we acquired Concept. This transaction further expands our addressable market by enabling us to address applications up to a gigawatt of power, including industrial motors, renewable energy systems and electric vehicles and giving us a presence in the energy generation and distribution markets in addition to the energy consumption market.

- *Capitalize on the growing demand for more energy-efficient electronic products and lighting technologies, cleaner modes of transportation and renewable sources of energy.* Because our products incorporate a variety of energy-efficiency technologies, we believe our ability to penetrate the target markets described above is enhanced by the desire on the part of policymakers and consumers to reduce energy consumption while also promoting cleaner energy sources. We believe that energy-efficiency is becoming an increasingly important design criterion for power supplies due largely to the emergence of standards and specifications that encourage, and in some cases mandate, the design of more energy-efficient electronic products. While power supplies built with competing technologies are often unable to meet these standards cost-effectively, power supplies incorporating our ICs are generally able to comply with all known efficiency specifications currently in effect.

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

The adoption of electric vehicles and renewable energy sources is another trend on which we intend to capitalize; we believe that low-cost, reliable, energy-efficient power-conversion electronics are essential to the success of these technologies, and we believe that the Concept transaction gives us the ability to offer solutions that compare favorably with competing alternatives in terms of cost, efficiency and reliability.

Recent Results

Our net revenues were $76.4 million and $148.2 million in the three and six months ended June 30, 2012, respectively, compared to $80.2 million and $156.9 million in the same periods of 2011. The decline was driven primarily by lower sales of our products into the communications, computer and consumer end markets, reflecting demand trends generally observed across the broader semiconductor industry, partially offset by an increase in the industrial end market due primarily to our acquisition of Concept. Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for 64% and 65% of our net revenues in the three and six months ended June 30, 2012, respectively, compared to 66% of our net revenues in both the three and six months ended June 30, 2011. Our top two customers, both distributors of our products, collectively accounted for approximately 33% of our net revenues in the both the three and six months ended June 30, 2012. In the same periods of the previous year, our top two customers, both distributors of our products, collectively accounted for approximately 33% and 32% of our net revenues, respectively. International sales accounted for 94% and 95% of our net revenues in the three and six months ended June 30, 2012, respectively, and 95% of our net revenues in both the three and six months ended June 30, 2011.

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

Our gross profit was $37.8 million, or 49.4% of net revenues, and $72.3 million, or 48.8% of net revenues, in the three and six months ended June 30, 2012, respectively, compared to $37.6 million, or 47% of net revenues, and $74.0 million, or 47% of net revenues, in the three and six months ended June 30, 2011, respectively. The increase in gross margin for these periods was due primarily to lower manufacturing costs, including more favorable wafer pricing from our foundries, our migration to next-generation, lower-cost process technology for certain of our products, and the completion of our conversion from five- to six-inch wafers. In the second quarter of 2012, the gross margin also increased due to a more favorable end market mix. These factors were partially offset by higher period costs in the second quarter of 2012 resulting from the amortization of intangibles and inventory write-up related to our acquisition of Concept (refer to Note 14, *Acquisitions* , in our Notes to Condensed Consolidated Financial Statements, for details).

Total operating expenses in the three and six months ended June 30, 2012 were $28.3 million and $54.2 million, respectively, and $24.4 million and $49.2 million in the same periods in 2011, respectively. The increase in both periods compared with the same periods in the prior year, was driven primarily by our acquisition of Concept in May 2012. The increase was primarily related to increased payroll and related expenses (including stock-based compensation expenses), due to increased headcount, and increased amortization of intangible assets, including the Concept tradename and customer relationships (refer to Note 14, *Acquisitions* , in our Notes to Condensed Consolidated Financial Statements, for details).

Our quarterly operating results are difficult to predict and subject to significant fluctuations. We plan our production and inventory levels based on internal forecasts of projected customer demand, which is highly unpredictable and can fluctuate substantially. Customers typically may cancel or reschedule orders on short notice without significant penalty and, conversely, often place orders with very short lead times to delivery. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile.

Critical Accounting Policies and Estimates

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

Our critical accounting policies are as follows:

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

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

Revenue recognition

Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. Approximately 73% of our net product sales were made to distributors in the six months ended June 30, 2012, and 71% in the twelve months ended December 31, 2011. We apply the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to our customer. We evaluate whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to collectability, we perform credit checks for new customers and perform ongoing evaluations of our existing customers' financial condition and requires letters of credit whenever deemed necessary.

Sales to international OEM customers and merchant power supply manufacturers that are shipped from our facility in California are pursuant to Delivered at Frontier, or DAF, shipping terms. 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. Sales to international OEMs and merchant power supply manufacturers for shipments from our facility outside of the United States are pursuant to EX Works, or EXW, shipping terms, meaning that title to the product transfers to the customer upon shipment from our foreign warehouse. Shipments to OEMs and merchant power supply manufacturers in the Americas are pursuant to Free on Board, or FOB, point of origin shipping terms 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.

Sales to most distributors are made under terms allowing certain price adjustments and rights of return on our products held by the distributors. As a result of these rights, we defer the recognition of revenue and the costs of revenues derived from sales to distributors until our distributors report that they have sold our products to their customers. Our recognition of such distributor sell-through is based on point of sales reports received from the distributor, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to us except pursuant to warranty terms. The gross profit that is deferred upon shipment to the distributor is reflected as “deferred income on sales to distributors” in the accompanying consolidated balance sheets. The total deferred revenue as of June 30, 2012 and December 31, 2011 was approximately $21.7 million and $16.7 million , respectively. The total deferred cost as of June 30, 2012 and December 31, 2011 was approximately $10.4 million and $8.8 million , respectively.

Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At or soon after the distributor invoices its customer, the distributor submits a “ship and debit” price adjustment claim to us to adjust the distributor's cost from the standard price to the pre-approved lower price. After we verify the claim, a credit memo is issued to the distributor for the ship and debit claim. We maintain a reserve for unprocessed claims and future ship and debit price adjustments. The reserve appears as a reduction to accounts receivable in our accompanying consolidated balance sheets. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on the deferred revenue and deferred margin ultimately recognized. To evaluate the adequacy of our reserves, we analyze historical ship and debit payments and levels of inventory in the distributor channels.

Sales to certain of our distributors are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, product revenue is recognized upon shipment and title transfer assuming all other revenue recognition criteria are met.

Stock-based compensation

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

Estimating write-downs for excess and obsolete inventory

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

Income taxes

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

We account for income taxes under the provisions of ASC 740. Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize valuation allowances to reduce any deferred tax assets to the amount that we estimate will more likely than not be realized based on available evidence and management's judgment. We limit the deferred tax assets recognized related to certain officers' compensation to amounts that we estimate will be deductible in future periods based upon Internal Revenue Code Section 162(m). In the event that we determine, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, we would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial position.

As of June 30, 2012, we continue to maintain a valuation allowance on a portion of our California deferred tax assets as we believe that it is not more likely than not that the deferred tax assets will be fully realized. We also maintain a valuation allowance with respect to some of our deferred tax assets relating primarily to tax credits in some non-U.S. jurisdictions.

In the quarter ended March 31, 2011, the IRS issued us a notice of proposed adjustments proposing material adjustments to our taxable income for fiscal years 2003 through 2006 related to our intercompany research and development cost-sharing arrangement and related issues. In December 2011, we received an addendum to the notice of proposed adjustments from the IRS related to our intercompany research-and-development cost-sharing arrangement. In the quarter ended June 30, 2012, we reached an understanding regarding the terms for settling with the IRS and closed out all positions as part of the examination of our income tax returns for the years 2003 through 2006. On August 2, 2012, the IRS signed a formal closing agreement with us that is consistent with the intentions of the parties pursuant to their earlier understanding. As a result, we remeasured our tax positions based on the facts, circumstances, and information available at the reporting date. In the course of the audit, the IRS examined and adjusted the valuation and payment arrangement for the non-exclusive license of specified intellectual property rights of Power Integrations, Inc. to a foreign subsidiary of the company. The consideration for the license was to be paid over time and was established based on our estimate of the ongoing royalties that would have been received in a similar arrangement with an unrelated third-party licensee. Pursuant to the closing agreement, we agreed to revise the valuation and accelerate royalty payments under the arrangement. The IRS also proposed adjustments to general and administrative expenses shared between Power Integrations, Inc. and its foreign subsidiary; we disagreed with the IRS on this matter but agreed to a resolution of the matter without respect to the technical merits.

Though we believe the IRS's position with respect to the adjustments is inconsistent with applicable tax law, and that we had a meritorious defense to our position, we elected to accept a negotiated agreement that we believe to be in the best interests of our stockholders. The agreement addresses the royalty issue for all tax years after 2003 (including the years 2007 - 2009, which are currently being audited by the IRS). Further, the agreement confirms that the royalty arrangement between us and our foreign subsidiary will end on October 31, 2012, resulting in a lower effective tax rate for us in future periods. Also, the agreement will allow us to repatriate up to $101.9 million from our foreign-based subsidiary in future periods without incurring U.S. income taxes.

Goodwill and intangible assets

In accordance with ASC 350-10, *Goodwill and Other Intangible Assets,* we evaluate goodwill for impairment on an annual basis, or as other indicators of impairment emerge. The provisions of ASC 350-10 require that we perform a two-step impairment test. In the first step, we compare the implied fair value of our single reporting unit to its carrying value, including goodwill. If the fair value of our reporting unit exceeds the carrying amount no impairment adjustment is required. If the carrying amount of our reporting unit exceeds the fair value, step two will be completed to measure the amount of goodwill impairment loss, if any exists. If the carrying value of our single reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference, but not in excess of the carrying amount of the goodwill. Under the amendments of this ASC, ASU No. 2011-08, *Testing Goodwill for Impairment,* beginning in the first quarter of 2012 we have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. We evaluated goodwill for impairment in the fourth quarter 2011, and concluded that no impairment existed as of December 31, 2011. Additionally, no impairment indicators have been identified during the six months ended June 30, 2012 .

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

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net revenues	100.0 %	100.0%	100.0%	100.0%
Cost of revenues	50.6	53.1	51.2	52.8
Gross profit	49.4	46.9	48.8	47.2
Operating expenses:				
Research and development	15.8	12.7	15.3	12.9
Sales and marketing	12.0	10.1	11.7	10.4
General and administrative	9.3	7.7	9.6	8.0
Total operating expenses	37.1	30.5	36.6	31.3
Income from operations	12.3	16.4	12.2	15.8
Other income, net	0.3	0.6	0.5	0.6
Income before provision for income taxes	12.6	17.0	12.7	16.4
Provision for income taxes	22.0	3.8	12.6	3.4
Net income (loss)	(9.4)%	13.2%	0.1%	13.0%

Comparison of the Three and Six Months Ended June 30, 2012 and 2011

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three and six months ended June 30, 2012 were $76.4 million and $148.2 million, respectively, compared with $80.2 million and $156.9 million for the same periods in 2011. The decrease in revenues for both the three- and six-month periods was driven primarily by lower sales of our products into the communications, computer and consumer end markets, reflecting demand trends generally observed across the broader semiconductor industry, partially offset by an increase in the industrial end market due primarily to our acquisition of Concept.

Our net revenue mix by end market for the three and six months ended June 30, 2012 , compared to the three and six months ended June 30, 2011 , were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
End Market	2012	2011	2012	2011
Consumer	36%	36%	38%	36%
Communications	24%	28%	25%	30%
Industrial	28%	23%	25%	22%
Computer	12%	13%	12%	12%

International sales, consisting of sales outside of the Americas based on “ship to” customer locations, were $71.9 million and $140.6 million in the three and six months ended June 30, 2012, and $76.4 million and $149.9 million in the same periods of 2011, respectively. Although the power supplies using our products are distributed to end markets worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region represented 81% and 82% of our net revenues for the three and six months ended June 30, 2012, and 84% of our net revenues for both the three and six months ended June 30, 2011. We expect international sales, and sales to the Asia region in particular, to continue to account for a large portion of our net revenues in the future.

Sales through distributors accounted for 73% and 75% of net revenues in the three and six months ended June 30, 2012, respectively and 70% and 69% of net revenues in the three and six months ended June 30, 2011, respectively, with direct sales to OEMs and power supply manufactures accounting for the remainder.

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

Customer	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
A	21%	19%	21%	19%
B	12%	14%	12%	13%

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

Gross profit. Gross profit is net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facility, and overhead associated with the management of our supply chain. Gross margin is gross profit divided by net revenues. The table below compares gross profit and gross margin for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net revenues	$76.4	$80.2	$148.2	$156.9
Gross profit	$37.8	$37.6	$72.3	$74.0
Gross margin	49.4%	46.9%	48.8%	47.2%

The increase in gross margin for the three and six months ended June 30, 2012, compared with the same periods in the prior year, was due primarily to lower manufacturing costs, including more favorable wafer pricing from our foundries, our migration to a lower-cost, next-generation process technology for certain of our products, and the completion of our conversion from five- to six-inch wafers. In the second quarter of 2012, our gross margin also increased due to a more favorable end market mix. These factors were partially offset by higher period costs in the second quarter of 2012 resulting from the amortization of intangible assets and an inventory write-up related to our acquisition of Concept. Refer to Note 14, *Acquisitions* , in our Notes to Condensed Consolidated Financial Statements, for details.

Research and development expenses. Research and development, or R&D, expenses consist primarily of employee-related expenses including stock-based compensation and expensed material and facility costs associated with the development of new processes and new products. We also record R&D expenses for prototype wafers related to new products until such products are released to production. The table below compares R&D expenses for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net revenues	$76.4	$80.2	$148.2	$156.9
R&D expenses	$12.1	$10.2	$22.7	$20.2
R&D expenses as a % of net revenue	15.8%	12.7%	15.3%	12.9%

R&D expenses increased in the three and six months ended June 30, 2012, compared to the same periods in 2011, driven primarily by increased payroll and related expenses, resulting from increased headcount, and increased stock-based compensation expense due to annual RSU awards granted to employees in addition to RSUs granted to Concept employees. Product-development expenses also increased for the three and six month periods ended June 30, 2012, compared to the same periods in 2011, due to expenses related to foundry qualifications and ongoing new-product development.

Sales and marketing expenses. Sales and marketing expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, and facilities expenses, including expenses associated with our regional sales and support offices. Sales and marketing expenses also include the amortization of acquisition-related intangible assets including tradenames and customer relationships. The table below compares sales and marketing expenses for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net revenues	$76.4	$80.2	$148.2	$156.9
Sales and marketing expenses	$9.2	$8.1	$17.3	$16.4
Sales and marketing expenses as a % of net revenue	12.0%	10.1%	11.7%	10.4%

Sales and marketing expenses increased in the three and six months ended June 30, 2012, compared to the same periods of 2011, due primarily to the acquisition of Concept, which resulted in increased expenses related to amortization of acquired intangible assets and increased headcount, which increased payroll and related expenses, including stock-based compensation expense.

General and administrative expenses. General and administrative, or G&A, expenses consist primarily of employee-related expenses, including stock-based compensation expenses for administration, finance, human resources and general management, as well as consulting, professional services, legal and auditing expenses. The table below compares G&A expenses for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net revenues	$76.4	$80.2	$148.2	$156.9
G&A expenses	$7.1	$6.1	$14.2	$12.6
G&A expenses as a % of net revenue	9.3%	7.7%	9.6%	8.0%

G&A expenses increased in the three and six months ended June 30, 2012 compared to the prior year, due primarily to the acquisition of Concept, which resulted in increased headcount as well as temporary increases in professional service expenses of $0.4 million and $0.9 million, respectively, associated with the transaction.

Other income, net . Other income, net consists primarily of interest income earned on cash and cash equivalents, marketable securities and other investments, and the impact of foreign exchange gain or loss. The table below compares other income, net for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net revenues	$76.4	$80.2	$148.2	$156.9
Other income	$0.2	$0.5	$0.8	$0.9
Other income as a % of net revenue	0.3%	0.6%	0.5%	0.6%

Other income, net, decreased in the three and six months ended June 30, 2012, compared to the same periods in 2011. The decrease was related to lower interest earned on cash and short term investments, which in turn was due to our purchase of Concept, which reduced our cash balance. The decrease was also partially driven by $0.6 million of expense related to a forward currency contract which was entered into and exercised in the second quarter of 2012 and the unfavorable revaluation impact of the U.S. dollar versus the Swiss franc. These factors were partially offset by interest earned on our $18.0 million promissory note with SemiSouth (refer to Note 15, *Investment in Third Party* , in our Notes to Condensed Consolidated Financial Statements, for details).

Provision for income taxes . Provision for income taxes represents federal, state and foreign taxes.
The table below compares income tax expenses for the three and six months ended June 30, 2012 and 2011 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Income before provision for income taxes	$9.6	$13.6	$18.9	$25.8
Provision for income taxes	$16.8	$3.0	$18.7	$5.3
Effective tax rate	174.7%	22.3%	98.5%	20.6%

Our effective tax rates for the three and six months ended June 30, 2012 were 174.7% and 98.5%, compared to 22.3% and 20.6% for the three months and six months ended June 30, 2011. In the three and six months ended June 30, 2012, the effective tax rate was higher than the expected statutory federal income tax rate of 35% primarily due to the audit agreement described in Note 9, *Provision for Income Taxes* , in our Notes to Condensed Consolidated Financial Statements. The agreement includes federal and state taxes plus interest charges totaling approximately $44.8 million, partially offset by the reversal of related unrecognized tax benefits and other items of $29.1 million, for a net charge of $15.7 million. Our effective tax rates for the periods ended June 30, 2011 were lower than the statutory rate due primarily to the geographic distribution of our earnings and the beneficial impact of the research and experimentation tax credit.

Liquidity and Capital Resources

As of June 30, 2012, we had $133.4 million in cash, cash equivalents and marketable securities, a decrease of approximately $79.4 million from $212.8 million as of December 31, 2011. As of June 30, 2012, and December 31, 2011, we had working capital, defined as current assets less current liabilities of $127.2 million and $217.5 million, respectively. The decrease in cash, cash equivalents and marketable securities and working capital resulted from the acquisition of Concept (refer to Note 14, *Acquisitions* , in our Notes to Condensed Consolidated Financial Statements, for details).

In February 2011,we entered into an unsecured credit agreement with a bank (the “Credit Agreement”). Pursuant to the Credit Agreement, we could request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of $50.0 million . On April 2, 2012 the amount available under this credit agreement was increased to $65.0 million , the proceeds of which could be used for working capital requirements and other general corporate purposes.

On July 5, 2012, we terminated the Credit Agreement and entered into a new Credit Agreement (the "New Credit Agreement") with two banks. The New Credit Agreement provides us with a $100.0 million revolving line of credit to use for general corporate purposes with a $20.0 million sublimit for the issuance of standby and trade letters of credit. Our ability to borrow under the revolving line of credit is conditioned upon our compliance with specified covenants, including reporting and financial covenants, primarily a modified current ratio and a debt to earnings ratio, with which we are currently in compliance. The New Credit Agreement terminates on July 5, 2015; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default.

In connection with entering into the New Credit Agreement, as of July 5, 2012, our existing $15.0 million letter of credit under the Credit Agreement with a bank, was deemed to have been issued pursuant to and subject to the terms and conditions of the New Credit Agreement. As of July 5, 2012, no amounts were outstanding under the terminated facility. Refer to Note 15, *Investment in Third Party,* for details on our outstanding letter of credit.

Operating activities generated cash of $49.1 million in the six months ended June 30, 2012. Net income for this period was $0.3 million; we also incurred non-cash depreciation, amortization of intangible assets and stock-based compensation expenses of $7.6 million, $1.5 million and $6.7 million, respectively. Significant changes in operating assets and liabilities included (1) a $14.1 million decline in inventory due to reduced wafer purchases, (2) a $8.8 million increase in taxes payable primarily due to the IRS agreement and (3) a $4.8 million decrease in deferred tax assets related to our agreement with the IRS, in addition to a tax depreciation refund claim. These sources of cash were partially offset by a $5.3 million increase in accounts receivable due to higher shipments in June 2012, compared to December 2011.

Operating activities generated cash of $40.6 million in the six months ended June 30, 2011. Our net income for this period was $20.5 million; we also incurred non-cash depreciation, amortization of intangible assets and stock-based compensation expenses of $7.5 million, $0.5 million and $4.9 million, respectively. Significant changes in operating assets and liabilities included (1) a $7.9 million decline in inventory due to reduced wafer purchases, and (2) a $3.0 million reduction in prepaid legal fees and prepaid inventory amortization. These sources of cash were partially offset by (1) a $4.3 million decrease in accounts payable resulting from the timing of payments processed and lower production volumes, and (2) a $2.4 million increase in accounts receivable due to the timing of cash collections in the fourth quarter of 2010 versus the second quarter of 2011.

Our investing activities in the six months ended June 30, 2012 resulted in a $127.6 million net use of cash, consisting of: (1) $113.4 million related to the acquisition of Concept, (2) $18.0 million for the issuance of a note receivable from SemiSouth (refer to Note 15, *Investment in Third Party* , for further details) and (3) $8.8 million for purchases of property and equipment, primarily manufacturing equipment to support our growth, and building improvements in connection with our research and development facility in New Jersey. These uses of cash were partially offset by $12.5 million of proceeds from maturities of marketable securities.

Our investing activities in the six months ended June 30, 2011 resulted in a $33.5 million net use of cash, consisting of (1) $12.5 million for purchases of property and equipment, (2) $6.9 million paid in relation to the acquisition of QSpeed, (3) $7.8 million in connection with our lease line of credit to SemiSouth (refer to Note 16, *Lease Line to Third Party* , of our Notes to Condensed Consolidated Financial Statements), (4) the issuance of a $3.0 million note to SemiSouth and (5) $4.9 million, net, for purchases of held-to-maturity investments. These uses of cash were partially offset by $2.0 million in proceeds from the sale of capital equipment.

Our financing activities in the three months ended June 30, 2012, resulted in net cash proceeds of $11.9 million. Financing activities consisted primarily of proceeds of $14.3 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan, partially offset by $2.9 million for the payment of dividends to stockholders. In the six months ended June 30, 2011, we received net proceeds of $7.7 million for financing activities, consisting primarily of $14.2 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan, partially off set by $4.4 million for the repurchase of our common stock and $2.9 million for the payment of dividends to stockholders.

On March 30, 2012, we entered into a definitive share purchase agreement, through our subsidiaries, to acquire Concept, a Swiss company, by acquiring all of the outstanding shares of its Swiss parent companies Concept Beteiligungen AG and CT-Concept Holding AG. We closed the acquisition on May 1, 2012. Pursuant to the purchase agreement, the purchase price is subject to a net asset value adjustment of approximately $2.4 million. The net asset value adjustment will be paid within approximately six months after May 1, 2012.

We paid dividends on a quarterly basis in 2011, which resulted in approximately a $1.4 million use of cash per quarter. In January 2012, our board of directors continued the dividend payments by declaring 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 2012. The first and second quarterly dividend payment of approximately $1.4 million per quarter was made on March 30, 2012 and June 29, 2012, with subsequent quarterly payments to be approximately the same amount. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of our stockholders.

As of June 30, 2012, we have an income tax obligation of approximately $42.6 million, as a result of the IRS agreement for the Company's income tax returns for the years 2003 through 2006.

As of June 30, 2012 we have a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately $10.1 million. The tax obligation was classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our condensed consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next year.

In the first quarter of 2011, the IRS informed us that it intended to propose material adjustments to our taxable income for fiscal years 2003 through 2006 related to our intercompany research and development cost-sharing arrangement and related issues. In December 2011, we received an addendum to the notice of proposed adjustments from the IRS related to our intercompany research-and-development cost-sharing arrangement. In the quarter ended June 30, 2012, we reached an agreement with the IRS to settle all positions and close out the examination of our income tax returns for the years 2003 through 2006. Under the agreement, in the third quarter of 2012, we will make a one-time payment of taxes and interest totaling approximately $42.6 million.

Though we believe the IRS's position with respect to the adjustments is inconsistent with applicable tax law, and that we had a meritorious defense to our position, we elected to accept a negotiated agreement that we believe to be in the best interests of our stockholders. The agreement addresses the royalty issue related to our international tax structure for all tax years after 2003 (including the years 2007 - 2009, which are currently being audited by the IRS). Further, the agreement confirms that the royalty arrangement between Power Integrations, Inc. and its foreign subsidiary will end on October 31, 2012, resulting in a substantially lower effective tax rate for us in future periods. Also, the agreement will allow us to repatriate up to $101.9 million from our foreign-based subsidiary in future periods without incurring U.S. income taxes.

In March 2012, we loaned $18.0 million to SemiSouth, and in exchange we were issued a promissory note. We intend to hold the note to maturity which occurs in March 2014. In connection with the note issuance we amended our 2010 agreement with SemiSouth to include a cap on the purchase price of $80.0 million under the Call and Put Option ("Purchase Option"). We estimated the value of the Purchase Option to be approximately $6.2 million using Level 2 inputs, refer to Note 4, *Fair Value Measurements* , in our Notes to Condensed Consolidated Financial Statements for valuation details. We accounted for the $18.0 million promissory note in Other Assets in our condensed consolidated balance sheet, net of the $6.2 million interest discount related to the Purchase Option. The interest discount will be amortized to interest income over the life of the promissory note. The amortization of the interest discount and the stated interest rate on the promissory note reflects the approximate fair value of the effective interest rate.

There were no other material changes, other than stated in the liquidity section above, outside of the ordinary course of business in our contractual commitments reported in our Annual Report on Form 10-K for the year ended December 31, 2011.

Our existing cash, cash equivalents and investment balances may change during the year due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to our acquisitions. Our intent is to permanently reinvest our earnings from foreign operations. Current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed, in addition to the $101.9 million we can repatriate in connection with our IRS agreement, to fund operations in the United States and if U.S. tax has not already been previously provided, we would be required to accrue and pay additional U.S. taxes in connection with the repatriation of any funds.

If our operating results deteriorate during the remainder of 2012, either as a result of a decrease in customer demand, or severe pricing pressures from our customers or our competitors, or for other reasons, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, use our credit agreement or seek additional financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

Recent Accounting Pronouncements

On January 1, 2012, we adopted the following accounting pronouncements:

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement,* ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). We adopted these amendments in the first quarter of 2012, and determined that the adoption did not have a material impact on our condensed consolidated financial statements.

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has not been a material change in our exposure to interest rate risks from that described in our 2011 Annual Report on Form 10-K.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and the fixed rate note receivable from SemiSouth. We consider cash invested in highly liquid financial instruments with a remaining maturity 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 are classified as short-term investments. In the first quarter of 2012, we changed our investment policy to allow the sale of long-term and short-term investments prior to their stated maturity date. We generally hold securities until maturity; however, they may now be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments. As a result of this change in policy we classify our investment portfolio as available-for-sale as opposed to held-to-maturity. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. At June 30, 2012 , and December 31, 2011 , we held primarily cash equivalents and short-term and long-term investments with fixed interest rates.

Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. To minimize market risk, most of our investments subject to market risk mature in less than one year, and therefore if market interest rates were to increase or decrease by 10% from interest rates as of June 30, 2012 or December 31, 2011, the increase or decrease in the fair market value of our portfolio on these dates would not have been material. We monitor our investments for impairment on a periodic basis. Refer to Note 2, *Summary of Significant Accounting Policies* , for a tabular presentation of our available-for-sale investments and the expected maturity dates.

Foreign Currency Exchange Risk. As of June 30, 2012, our primary transactional currency was in U.S. dollars; in addition, we hold cash in Swiss francs as a result of our acquisition of Concept. We completed the acquisition of Concept, which is located in Biel, Switzerland, in the second quarter of 2012. Included in the assets acquired was cash denominated in Swiss francs, which will be used to fund Concept operations. Cash balances held in foreign countries are subject to local banking laws and may bear higher or lower risk than cash deposited in the United States. The following represents the potential impact on our income, before provision for income tax, of a change in the value of the U.S. dollar compared to the Swiss franc as of June 30, 2012. This sensitivity analysis applies a change in the U.S. dollar value of 5% and 10%.

	June 30, 2012 5%	June 30, 2012 10%
Swiss Franc foreign exchange impact (in thousands of USD)	$ 400	$ 800

The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc is recorded in other income in our condensed consolidated statements of income (loss).

We have sales offices in various other foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. From time to time we may enter into foreign currency hedging contracts to hedge certain foreign currency transactions. As of June 30, 2012, and December 31, 2011, we did not have an open foreign currency hedge program utilizing foreign currency forward exchange contracts.

Two of our major suppliers, Seiko Epson Corporation, or Epson, and ROHM Lapis Semiconductor Co., Ltd., or Lapis, have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between Power Integrations and each of these suppliers.

Nevertheless, as a result of our above-mentioned supplier agreements, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. All else being equal, a 10% change in the value of the U.S.

dollar compared to the Japanese yen would result in a corresponding change in our gross margin of approximately 1 percentage point; this sensitivity may increase or decrease depending on the percentage of our wafer supply that we purchase from some of our Japanese suppliers and could subject our gross profit and operating results to the potential for material fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

Limitation on Effectiveness of Controls

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

Evaluation of Disclosure Controls and Procedures

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

On May 1, 2012 we completed the acquisition of Concept. We have not completed integrating Concept into our systems and control environment as of June 30, 2012 . We believe that we have taken the necessary steps to monitor and maintain appropriate internal control over financial reporting during this integration. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2012 , which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

In addition to the other information in this report, the following factors should be considered carefully in evaluating our business before purchasing shares of our stock. The risks facing our business have not changed substantively from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2011, except for those risk factors below designated by an asterisk (*).

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

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

- the demand for our products declining in the major end markets we serve, which may occur due to competitive factors, supply-chain fluctuations or changes in macroeconomic conditions;
- competitive pressures on selling prices;
- the inability to adequately protect or enforce our intellectual property rights;
- expenses we are required to incur (or choose to incur) in connection with our intellectual property litigations;
- reliance on international sales activities for a substantial portion of our net revenues;
- risks associated with acquisitions and strategic investments;
- our ability to successfully integrate, or realize the expected benefits from, our acquisitions;
- fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen and Swiss franc;
- the volume and timing of delivery of orders placed by us with our wafer foundries and assembly subcontractors, and their ability to procure materials;
- our ability to develop and bring to market new products and technologies on a timely basis;
- earthquakes, terrorists acts or other disasters;
- continued impact of recently enacted changes in securities laws and regulations, including potential risks resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002;
- the lengthy timing of our sales cycle;
- undetected defects and failures in meeting the exact specifications required by our products;
- the ability of our products to penetrate additional markets;
- the volume and timing of orders received from customers;
- an audit by the Internal Revenue Service, for fiscal years 2007 - 2009;
- our ability to attract and retain qualified personnel;
- changes in environmental laws and regulations, including with respect to energy consumption and climate change; and
- interruptions in our information technology systems.

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

Intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products. The high-voltage power supply industry is intensely competitive and characterized by significant price sensitivity. Our products face competition from alternative technologies, such as linear transformers, discrete

switcher power supplies, and other integrated and hybrid solutions. If the price of competing solutions decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized go outside the cost-effective range of our products, some of these alternative technologies can be used more cost effectively. In addition, as our patents expire, our competitors could legally begin using the technology covered by the expired patents in their products, potentially increasing the performance of their products and/or decreasing the cost of their products, which may enable our competitors to compete more effectively. Our current patents may or may not inhibit our competitors from getting any benefit from an expired patent. Our U.S. patents have expiration dates ranging from 2012 to 2029. We cannot assure that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market. We believe our failure to compete successfully in the high-voltage power supply business, including our ability to introduce new products with higher average selling prices, would materially harm our operating results.

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

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

If we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies. We are currently involved in a number of patent litigation matters and the outcome of the litigation is uncertain. See Note 10, *Legal Proceedings and Contingencies* , in our Notes to Consolidated Financial Statements. For example, in one of our patent suits the infringing company has been found to infringe four of our patents. Despite the favorable court finding, the infringing party filed an appeal to the damages awarded. In another matter, we are being sued for patent infringement in China, where the outcome of litigation can be more uncertain than in the United States. Should we ultimately be determined to be infringing on another party's patents, or if an injunction is issued against us while litigation is pending on those claims, such result could have an adverse impact on our ability to sell products found to be infringing, either directly or indirectly. In the event of an adverse outcome, we may be required to pay substantial damages, stop our manufacture, use, sale, or importation of infringing products, or obtain licenses to the intellectual property we are found to have infringed. We have also incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits, including the appeal of the case we won, and our involvement in this litigation and any future intellectual property litigation could adversely affect sales and divert the efforts and attention of our technical and management personnel, whether or not such litigation is resolved in our favor. Thus, even if we are successful in these lawsuits, the benefits of this success may fail to outweigh the significant legal costs we will have incurred.

Our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. Sales to customers outside of the Americas account for, and have accounted for a large portion of our net revenues, including approximately 95% of our net revenues for six months ended June 30, 2012 and 96% of our net revenues for the year ended December 31, 2011. If our international sales declined and we were unable to increase domestic sales, our revenues would decline and our operating results would be harmed. International sales involve a number of risks to us, including:

- potential insolvency of international distributors and representatives;
- reduced protection for intellectual property rights in some countries;
- the impact of recessionary environments in economies outside the United States;

- tariffs and other trade barriers and restrictions;
- the burdens of complying with a variety of foreign and applicable U.S. Federal and state laws; and
- foreign-currency exchange risk.

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

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

- inability to realize anticipated benefits, which may occur due to any of the reasons described below, or for other unanticipated reasons;
- the risk of litigation or disputes with customers, suppliers, partners or stockholders of an acquisition target arising from a proposed or completed transaction;
- impairment of acquired intangible assets and goodwill as a result of changing business conditions, technological advancements or worse-than-expected performance, which would adversely affect our financial results; and
- unknown, underestimated and/or undisclosed commitments, liabilities or issues not discovered in our due diligence of such transactions.

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

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

**Fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen and Swiss franc, may impact our gross margin and net income* . Our exchange rate risk related to the Japanese yen includes two of our major suppliers, Epson and Lapis, that have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between Power Integrations and each of these suppliers. We completed the acquisition of Concept in the second quarter of 2012, which is located in Biel, Switzerland. Included in the assets acquired was cash denominated in Swiss francs, which will be used to fund Concept operations. The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc is recorded in other income in our condensed consolidated statements of income, and material unfavorable exchange rate fluctuations with the Swiss franc could negatively impact our net income.

We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient quantities of wafers, our business may suffer . We have supply arrangements for the production of wafers with Lapis, Renesas, X-FAB and Epson. Our contracts with these suppliers expire in April 2018, August 2014, December 2012 and December 2020, respectively. Although some aspects of our relationships with Lapis, Renesas, X-FAB and Epson are contractual, many important aspects of these relationships depend on their continued cooperation. We cannot assure that we will continue to work successfully with Lapis, Renesas, X-FAB and Epson in the future, and that the wafer foundries' capacity will meet our needs.

Additionally, one or more of these wafer foundries could seek an early termination of our wafer supply agreements. Any serious disruption in the supply of wafers from Lapis, Renesas, X-FAB or Epson could harm our business. We estimate that it would take 12 to 24 months from the time we identified an alternate manufacturing source to produce wafers with acceptable manufacturing yields in sufficient quantities to meet our needs.

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

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

In addition, if prices for commodities used in our products increase significantly, raw material costs would increase for our suppliers which could result in an increase in the prices our suppliers charge us. To the extent we are not able to pass these costs on to our customers; this would have an adverse effect on our gross margins.

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

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

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

Securities laws and regulations, including potential risk resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002, will continue to impact our results . Complying with the requirements of the Sarbanes-Oxley Act of 2002 and NASDAQ's conditions for continued listing have imposed significant legal and financial compliance costs, and are expected to continue to impose significant costs and management burden on us. These rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly qualified members to serve on our audit committee. Further, the rules and regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which became effective in 2011, may impose significant costs and management burden on us.

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

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

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

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

We do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and our business may suffer. Our business is characterized by short-term customer orders and shipment schedules, and the ordering patterns of some of our large customers have been unpredictable in the past and will likely remain unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without significant penalty to the customer. In the past, we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time. Also, a relatively small number of distributors, OEMs and merchant power supply manufacturers account for a significant portion of our revenues. Specifically, our top ten customers, including distributors, accounted for 65% of our net revenues in the six months ended June 30, 2012 , and 62% of our net revenues for the year ended December 31, 2011. However, a significant portion of these revenues are attributable to sales of our products through distributors of electronic components. These distributors sell our products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers, which mitigates the risk of customer concentration to a large degree.

**The IRS is auditing us for fiscal years 2007 through 2009. If the IRS challenges any of the tax positions we have taken and we are not successful in defending our positions, we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future.* Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by the IRS and state, local and foreign tax authorities.

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

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

Interruptions in our information technology systems could adversely affect our business. We rely on the efficient and uninterrupted operation of complex information technology systems and networks to operate our business. Any significant system or network disruption, including but not limited to new system implementations, computer viruses, security breaches, or energy blackouts could have a material adverse impact on our operations, sales and operating results. We have implemented measures to manage our risks related to such disruptions, but such disruptions could still occur and negatively impact our operations and financial results. In addition, we may incur additional costs to remedy any damages caused by these disruptions or security breaches.

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

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

In November 2011, our board of directors authorized the use of $30.0 million for the repurchase of our common stock. In the first quarter of 2012, in connection with the execution of our acquisition of Concept, our board of directors canceled this stock repurchase program. Authorization of future stock repurchase programs are at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions as well as other factors.

ITEM 5. OTHER INFORMATION

IRS Income Tax Audit Settlement

On August 2, 2012, we entered into a Closing Agreement with the Internal Revenue Service, or IRS, pursuant to which it settled all positions and closed out the examination of the Power Integrations income tax returns for the years 2003 through 2006. As a result of the Closing Agreement, we will pay to the IRS, in the third quarter of 2012, a one-time payment of taxes and interest totaling $42.3 million.

Comprehensive Income

In June 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-05, *Presentation of Comprehensive Income* , which requires companies to present the components of net income and other comprehensive income either in a single continuous statement or in two separate but consecutive statements. ASU No. 2011-05 eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. ASU No. 2011-05 does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. Additionally, ASU No. 2011-05 does not affect the calculation or reporting of earnings per share. ASU 2011-05 is effective for reporting periods beginning after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* . ASU No. 2011-12 defers the changes in ASU No. 2011-05 that pertain to how, when and where reclassification adjustments are presented. We adopted these ASUs retrospectively effective January 1, 2012, and elected to present comprehensive income in a separate statement immediately following the condensed consolidated statements of income (loss). The adoption had no effect on our financial position, results of operations or cash flows. The impact of the adoption to previously issued consolidated financial statements is the presentation of comprehensive income in a separate statement as follows:

	Year Ended December 31,		
	2011	**2010**	**2009**
Net income	$ 34,291	$ 49,464	$ 23,269
Other comprehensive income, net of tax			
Foreign currency translation adjustments	(35)	81	61
Total other comprehensive income	(35)	81	61
Total comprehensive income	$ 34,256	$ 49,545	$ 23,330

ITEM 6. EXHIBITS

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

SIGNATURES

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

		POWER INTEGRATIONS, INC.	
Dated:	August 6, 2012	By:	/s/ SANDEEP NAYYAR
			Sandeep Nayyar Chief Financial Officer (Duly Authorized Officer and Principal Financial Officer and Chief Accounting Officer)

INDEX TO EXHIBITS

EXHIBIT NUMBER	DESCRIPTION
2.1	Share Purchase Agreement, dated March 30, 2012, by and between Heinz Rüedi, Power Integrations Netherlands B.V. and Power Integrations Limited regarding shares of Concept Beteiligungen AG and CT-Concept Holding AG. (As filed with the SEC as Exhibit 2.01 to our Current Report on Form 8-K on May 7, 2012, SEC File No. 000-23441.)*
3.1	Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Annual Report on Form 10-K on February 29, 2012, SEC File No. 000-23441.)
3.2	Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.1 to our Current Report on Form 8-K on January 30, 2012, SEC File No. 000-23441.)
4.1	Reference is made to Exhibits 3.1 and 3.2.
10.1	Second Amendment to Credit Agreement, dated April 2, 2012, by and between Power Integrations, Inc. and Wells Fargo Bank, National Association. (As filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q filed with the SEC on May 8, 2012, SEC File No. 000-23441.)
10.2	2007 Equity Incentive Plan, as amended and restated
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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

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* Confidential treatment has been requested for portions of this exhibit.

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

Exhibit 10.2

Power Integrations, Inc.

2007 Equity Incentive Plan

Adopted by the Board: September 10, 2007
Approved by the Stockholders: November 7, 2007
Amended by the Board: January 29, 2008
Amended by the Board: July 28, 2009
Amended by the Board: March 27, 2012
Approved by the Stockholders: June 18, 2012
Termination Date: September 9, 2017

1. General.

(a) Amendment and Restatement. The Plan is adopted to amend and restate the Company's 1997 Stock Option Plan (the " ***Original Plan*** "). All outstanding Stock Awards granted before the amendment and restatement of the Plan shall continue to be governed by the terms of the Original Plan. All Stock Awards granted after the Effective Date shall be governed by the terms contained herein.

(b) Eligible Stock Award Recipients. The persons eligible to receive Stock Awards are Employees, Directors and Consultants.

(c) Available Stock Awards. The Plan provides for the grant of the following Stock Awards: (i) Incentive Stock Options, (ii) Nonstatutory Stock Options, (iii) Restricted Stock Awards, (iv) Restricted Stock Unit Awards, (v) Stock Appreciation Rights, (vi) Performance Stock Awards, and (vii) Other Stock Awards.

(d) Purpose. The Company, by means of the Plan, seeks to secure and retain the services of the group of persons eligible to receive Stock Awards as set forth in Section 1(b), to provide incentives for such persons to exert maximum efforts for the success of the Company and any Affiliate, and to provide a means by which such eligible recipients may be given an opportunity to benefit from increases in value of the Common Stock through the granting of Stock Awards.

2. Administration.

(a) Administration by Board. The Board shall administer the Plan unless and until the Board delegates administration of the Plan to a Committee or Committees, as provided in Section 2(c).

(b) Powers of Board. The Board shall have the power, subject to, and within the limitations of, the express provisions of the Plan:

(i) To determine from time to time (A) which of the persons eligible under the Plan shall be granted Stock Awards; (B) when and how each Stock Award shall be granted; (C) what type or combination of types of Stock Award shall be granted; (D) the provisions of each Stock Award granted (which need not be identical), including the time or times when a person shall be permitted to receive cash or Common Stock pursuant to a Stock Award; (E) the number of shares of Common Stock with respect to which a Stock Award shall be granted to each such person; and (F) the Fair Market Value applicable to a Stock Award.

(ii) To construe and interpret the Plan and Stock Awards granted under it, and to establish, amend and revoke rules and regulations for administration of the Plan. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Stock Award Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan or Stock Award fully effective.

(iii) To settle all controversies regarding the Plan and Stock Awards granted under it.

(iv) To accelerate the time at which a Stock Award may first be exercised or the time during which a Stock Award or any part thereof will vest in accordance with the Plan, notwithstanding the provisions in the Stock Award stating the time at which it may first be exercised or the time during which it will vest.

(v) To suspend or terminate the Plan at any time. Suspension or termination of the Plan shall not impair rights and obligations under any Stock Award granted while the Plan is in effect except with the written consent of the affected Participant.

(vi) To amend the Plan in any respect the Board deems necessary or advisable, including, without limitation, relating to Incentive Stock Options and certain nonqualified deferred compensation under Section 409A of the Code and/or to bring the Plan or Stock Awards granted under the Plan into compliance therewith, subject to the limitations, if any, of applicable law. However, except as provided in Section 9(a) relating to Capitalization Adjustments, to the extent required by applicable law or listing requirements, stockholder approval shall be required for any amendment of the Plan that either (i) materially increases the number of shares of Common Stock available for issuance under the Plan, (ii) materially expands the class of individuals eligible to receive Stock Awards under the Plan, (iii) materially increases the benefits accruing to Participants under the Plan or materially reduces the price at which shares of Common Stock may be issued or purchased under the Plan, (iv) materially extends the term of the Plan, or (v) expands the types of Stock Awards available for issuance under the Plan. Except as provided above, rights under any Stock Award granted before amendment of the Plan shall not be impaired by any amendment of the Plan unless (i) the Company requests the consent of the affected Participant, and (ii) such Participant consents in writing.

(vii) To submit any amendment to the Plan for stockholder approval, including, but not limited to, amendments to the Plan intended to satisfy the requirements of (i) Section 162(m) of the Code and the regulations thereunder regarding the exclusion of performance-based compensation from the limit on corporate deductibility of compensation paid to Covered Employees, (ii) Section 422 of the Code regarding Incentive Stock Options, or (iii) Rule 16b-3.

(viii) To approve forms of Stock Award Agreements for use under the Plan and to amend the terms of any one or more Stock Awards, including, but not limited to, amendments to provide terms more favorable than previously provided in the Stock Award Agreement, subject to any specified limits in the Plan that are not subject to Board discretion; *provided however*, that, the rights under any Stock Award shall not be impaired by any such amendment unless (i) the Company requests the consent of the affected Participant, and (ii) such Participant consents in writing. Notwithstanding the foregoing, subject to the limitations of applicable law, if any, the Board may amend the terms of any one or more Stock Awards without the affected Participant's consent if necessary to maintain the qualified status of the Stock Award as an Incentive Stock Option or to bring the Stock Award into compliance with Section 409A of the Code and the related guidance thereunder.

(ix) Generally, to exercise such powers and to perform such acts as the Board deems necessary or expedient to promote the best interests of the Company and that are not in conflict with the provisions of the Plan or Stock Awards.

(x) To adopt such procedures and sub-plans as are necessary or appropriate to permit participation in the Plan by Employees, Directors or Consultants who are foreign nationals or employed outside the United States.

(c) Delegation to Committee.

(i) **General.** The Board may delegate some or all of the administration of the Plan to a Committee or Committees. If administration of the Plan is delegated to a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board that have been delegated to the Committee, including the power to delegate to a subcommittee of the Committee any of the administrative powers the Committee is authorized to exercise (and references in the Plan to the Board shall thereafter be to the Committee or subcommittee), subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may retain the authority to concurrently administer the Plan with the Committee and may, at any time, revest in the Board some or all of the powers previously delegated.

(ii) **Section 162(m) and Rule 16b-3 Compliance.** In the sole discretion of the Board, the Committee may consist solely of two or more Outside Directors, in accordance with Section 162(m) of the Code, or solely of two or more Non-Employee Directors, in accordance with Rule 16b-3. In addition, the Board or the Committee, in its sole discretion, may (A) delegate to a Committee who need not be Outside Directors the authority to grant Stock Awards to eligible persons who are either (I) not then Covered Employees and are not expected to be Covered Employees at the time of recognition of income resulting from such Stock Award, or (II) not persons with respect to whom the Company wishes to comply with Section 162(m) of the Code, or (B) delegate to a Committee who need not be Non-Employee Directors the authority to grant Stock Awards to eligible persons who are not then subject to Section 16 of the Exchange Act.

(d) Delegation to Officers. The Board may delegate to one or more Officers the authority to do one or both of the following: (i) designate Officers and Employees of the Company or any of its Subsidiaries to be recipients of Options (and, to the extent permitted by Delaware law, other Stock Awards) and the terms thereof, and (ii) determine the number of shares of Common Stock to be subject to such Stock Awards granted to such Officers and Employees; *provided*, *however*, that the Board resolutions regarding such delegation shall specify the total number of shares of Common Stock that may be subject to the Stock Awards granted by such Officers and that such Officer may not grant a Stock Award to himself or herself. Notwithstanding the foregoing, the Board may not delegate to an Officer authority to determine the Fair Market Value of the Common Stock pursuant to Section 13(u)(ii) below.

(e) Cancellation and Re-Grant of Stock Awards . Neither the Board nor any Committee shall have the authority to: (i) reprice any outstanding Stock Awards under the Plan, or (ii) cancel and re-grant any outstanding Stock Awards under the Plan, unless the stockholders of the Company have approved such an action within a twelve (12) month period preceding or following such an event.

(f) Repurchase of Stock Awards . Notwithstanding anything to the contrary set forth herein, except in connection with an Ownership Change Event, Capitalization Adjustment, extraordinary cash dividend, split-up or spin-off, outstanding Options or Stock Appreciation Rights may not be canceled in exchange for cash without stockholder approval.

(g) **Effect of Board's Decision.** All determinations, interpretations and constructions made by the Board in good faith shall not be subject to review by any person and shall be final, binding and conclusive on all persons.

3. Shares Subject to the Plan.

(a) **Share Reserve** . Subject to the provisions of Section 9(a) relating to Capitalization Adjustments, the aggregate number of shares of Common Stock that may be issued pursuant to Stock Awards under the Plan shall not exceed Fourteen Million Seven Hundred Ninety-Six Thousand Nine Hundred Twenty-Nine (14,796,929) shares. Subject to Section 3(b), the number of shares available for issuance under the Plan shall be reduced by: (i) one (1) share for each share of stock issued pursuant to (A) an Option granted under Section 5, or (B) a Stock Appreciation Right granted under Section 6(c), and (ii) two (2) shares for each share of Common Stock issued pursuant to a Restricted Stock Award, Restricted Stock Unit Award, or Other Stock Award granted under Section 6. Shares may be issued in connection with a merger or acquisition as permitted by Nasdaq Rule 4350(i)(1)(A)(iii) or, if applicable, NYSE Listed Company Manual Section 303A.08, or AMEX Company Guide Section 711 and such issuance shall not reduce the number of shares available for issuance under the Plan.

(b) **Reversion of Shares to the Share Reserve** . If any (i) Stock Award shall for any reason expire or otherwise terminate, in whole or in part, without having been exercised in full, (ii) shares of Common Stock issued to a Participant pursuant to a Stock Award are forfeited to or repurchased by the Company because of the failure to meet a contingency or condition required for the vesting of such shares, or (iii) a Stock Award is settled in cash, then the shares of Common Stock not issued under such Stock Award, or forfeited to or repurchased by the Company, shall revert to and again become available for issuance under the Plan. If any shares subject to a Stock Award are not delivered to a Participant because such shares are withheld for the payment of taxes or the Stock Award is exercised through a reduction of shares subject to the Stock Award (*i.e.* , “net exercised”) or an appreciation distribution in respect of a Stock Appreciation Right is paid in shares of Common Stock, the number of shares subject to the Stock Award that are not delivered to the Participant shall not remain available for subsequent issuance under the Plan. If the exercise price of any Stock Award is satisfied by tendering shares of Common Stock held by the Participant (either by actual delivery or attestation), then the number of shares so tendered shall not remain available for issuance under the Plan. To the extent there is issued a share of Common Stock pursuant to a Stock Award that counted as two (2) shares against the number of shares available for issuance under the Plan pursuant to Section 3(a) and such share of Common Stock again becomes available for issuance under the Plan pursuant to this Section 3(b), then the number of shares of Common Stock available for issuance under the Plan shall increase by two (2) shares.

(c) **Incentive Stock Option Limit.** Notwithstanding anything to the contrary in Section 3, subject to the provisions of Section 9(a) relating to Capitalization Adjustments the aggregate maximum number of shares of Common Stock that may be issued pursuant to the exercise of Incentive Stock Options shall be Fourteen Million Seven Hundred Ninety-Six Thousand Nine Hundred Twenty-Nine (14,796,929) shares of Common Stock.

(d) **Source of Shares.** The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Company on the open market.

4. Eligibility.

(a) Eligibility for Specific Stock Awards . Incentive Stock Options may be granted only to employees of the Company or a "parent corporation" or "subsidiary corporation" thereof (as such terms are defined in Sections 424(e) and 424(f) of the Code). Stock Awards other than Incentive Stock Options may be granted to Employees, Directors and Consultants.

(b) Ten Percent Stockholders. A Ten Percent Stockholder shall not be granted an Incentive Stock Option unless the exercise price of such Option is at least one hundred ten percent (110%) of the Fair Market Value of the Common Stock on the date of grant and the Option is not exercisable after the expiration of five (5) years from the date of grant.

(c) Section 162(m) Limitation . Subject to the provisions of Section 9(a) relating to Capitalization Adjustments, no Employee shall be eligible to be granted during any calendar year Stock Awards whose value is determined by reference to an increase over an exercise or strike price of at least one hundred percent (100%) of the Fair Market Value of the Common Stock on the date the Stock Award is granted covering more than five hundred thousand (500,000) shares of Common Stock.

(d) Consultants. A Consultant shall be eligible for the grant of a Stock Award only if, at the time of grant, a Form S-8 Registration Statement under the Securities Act (" ***Form S-8*** ") is available to register either the offer or the sale of the Company's securities to such Consultant because of the nature of the services that the Consultant is providing to the Company, because the Consultant is not a natural person, or because of any other rule governing the availability of Form S-8.

5. Option Provisions.

Each Option shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. All Options shall be separately designated Incentive Stock Options or Nonstatutory Stock Options at the time of grant, and, if certificates are issued, a separate certificate or certificates shall be issued for shares of Common Stock purchased on exercise of each type of Option. If an Option is not specifically designated as an Incentive Stock Option, then the Option shall be a Nonstatutory Stock Option. The provisions of separate Options need not be identical; *provided, however* , that each Option Agreement shall conform to (through incorporation of provisions hereof by reference in the Option Agreement or otherwise) the substance of each of the following provisions:

(a) Term. Subject to the provisions of Section 4(b) regarding Ten Percent Stockholders, no Option shall be exercisable after the expiration of ten (10) years from the date of its grant or such shorter period specified in the Option Agreement.

(b) Exercise Price. Subject to the provisions of Section 4(b) regarding Ten Percent Stockholders, the exercise price of each Option shall be not less than one hundred percent (100%) of the Fair Market Value of the Common Stock subject to the Option on the date the Option is granted. Notwithstanding the foregoing, an Option may be granted with an exercise price lower than one hundred percent (100%) of the Fair Market Value of the Common Stock subject to the Option if such Option is granted pursuant to an assumption or substitution for another option in a manner consistent with the provisions of Section 424(a) of the Code (whether or not such options are Incentive Stock Options).

(c) Consideration. The purchase price of Common Stock acquired pursuant to the exercise of an Option shall be paid, to the extent permitted by applicable law and as determined by the Board in its sole discretion, by any combination of the methods of payment set forth below. The Board shall have the authority to grant Options that do not permit all of the following methods of payment (or otherwise restrict the ability to use certain methods) and to grant Options that require the consent of the Company to utilize a particular method of payment. The permitted methods of payment are as follows:

(i) by cash, check, bank draft or money order payable to the Company;

(ii) pursuant to a program developed under Regulation T as promulgated by the Federal Reserve Board that, prior to the issuance of the stock subject to the Option, results in either the receipt of cash (or check) by the Company or the receipt of irrevocable instructions to pay the aggregate exercise price to the Company from the sales proceeds;

(iii) by delivery to the Company (either by actual delivery or attestation) of shares of Common Stock;

(iv) by a "net exercise" arrangement pursuant to which the Company will reduce the number of shares of Common Stock issued upon exercise by the largest whole number of shares with a Fair Market Value that does not exceed the aggregate exercise price; *provided, however,* that the Company shall accept a cash or other payment from the Participant to the extent of any remaining balance of the aggregate exercise price not satisfied by such reduction in the number of whole shares to be issued; *provided, further*, that shares of Common Stock will no longer be outstanding under an Option and will not be exercisable thereafter to the extent that (A) shares are used to pay the exercise price pursuant to the "net exercise," (B) shares are delivered to the Participant as a result of such exercise, and (C) shares are withheld to satisfy tax withholding obligations; or

(v) in any other form of legal consideration that may be acceptable to the Board in its sole discretion and permissible under applicable law.

(d) Transferability of Options. The Board may, in its sole discretion, impose such limitations on the transferability of Options as the Board shall determine. In the absence of such a determination by the Board to the contrary, the following restrictions on the transferability of Options shall apply:

(i) **Restrictions on Transfer.** An Option shall not be transferable except by will or by the laws of descent and distribution and shall be exercisable during the lifetime of the Optionholder only by the Optionholder; *provided*, *however* , that the Board may, in its sole discretion, permit transfer of the Option in a manner that is not prohibited by applicable tax and securities laws upon the Optionholder's request.

(ii) **Domestic Relations Orders.** Notwithstanding the foregoing, an Option may be transferred pursuant to a domestic relations order, *provided, however,* that an Incentive Stock Option may be deemed to be a Nonstatutory Stock Option as a result of such transfer.

(iii) **Beneficiary Designation.** Notwithstanding the foregoing, the Optionholder may, by delivering written notice to the Company, in a form provided by or otherwise satisfactory to the Company and any broker designated by the Company to effect Option exercises, designate a third party who, in the event of the death of the Optionholder, shall thereafter be entitled to exercise the Option. In the absence of such a designation, the executor or administrator of the Optionholder's estate shall be entitled to exercise the Option.

(e) Vesting of Options Generally. The total number of shares of Common Stock subject to an Option may vest and therefore become exercisable in periodic installments that may or may not be equal. The Option may be subject to such other terms and conditions on the time or times when it may or may not be exercised (which may be based on performance or other criteria) as the Board may deem appropriate. The vesting provisions of individual Options may vary. The provisions of this Section 5(e) are subject to any Option provisions governing the minimum number of shares of Common Stock as to which an Option may be exercised.

(f) Termination of Continuous Service. In the event that an Optionholder's Continuous Service terminates (other than upon the Optionholder's death or Disability), the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination of Continuous Service) but only within such period of time ending on the earlier of (i) the date three (3) months following the termination of the Optionholder's Continuous Service (or such longer or shorter period specified in the Option Agreement), or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination of Continuous Service, the Optionholder does not exercise his or her Option within the time specified herein or in the Option Agreement (as applicable), the Option shall terminate

(g) Extension of Termination Date. In the event that exercise of an Option following the termination of the Optionholder's Continuous Service (other than upon the Optionholder's death or Disability) would be prohibited at any time solely because the issuance of shares of Common Stock would violate the registration requirements under the Securities Act, then the Option shall terminate on the earlier of (i) the expiration of a period of three (3) months after the termination of the Optionholder's Continuous Service during which the exercise of the Option would not be in violation of such registration requirements, or (ii) the expiration of the term of the Option as set forth in the Option Agreement.

(h) Disability of Optionholder. In the event that an Optionholder's Continuous Service terminates as a result of the Optionholder's Disability, the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination of Continuous Service), but only within such period of time ending on the earlier of (i) the date twelve (12) months following such termination of Continuous Service (or such longer or shorter period specified in the Option Agreement), or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination of Continuous Service, the Optionholder does not exercise his or her Option within the time specified herein or in the Option Agreement (as applicable), the Option shall terminate.

(i) Death of Optionholder. In the event that (i) an Optionholder's Continuous Service terminates as a result of the Optionholder's death, or (ii) the Optionholder dies within the period (if any) specified in the Option Agreement after the termination of the Optionholder's Continuous Service for a reason other than death, then the Option may be exercised (to the extent the Optionholder was entitled to exercise such Option as of the date of death) by the Optionholder's estate, by a person who acquired the right to exercise the Option by bequest or inheritance or by a person designated to exercise the option upon the Optionholder's death, but only within the period ending on the earlier of (i) the date eighteen (18) months following the date of death (or such longer or shorter period specified in the Option Agreement), or (ii) the expiration of the term of such Option as set forth in the Option Agreement. If, after the Optionholder's death, the Option is not exercised within the time specified herein or in the Option Agreement (as applicable), the Option shall terminate.

(j) Non-Exempt Employees . No Option granted to an Employee that is a non-exempt employee for purposes of the Fair Labor Standards Act of 1938, as amended, shall be first exercisable for any shares of Common Stock until at least six months following the date of grant of the Option. The foregoing provision is intended to operate so that any income derived by a non-exempt employee in connection with the exercise or vesting of an Option will be exempt from his or her regular rate of pay.

6. Provisions of Stock Awards other than Options

(a) **Restricted Stock Awards.** Each Restricted Stock Award Agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. To the extent consistent with the Company's Bylaws, at the Board's election, shares of Common Stock may be (x) held in book entry form subject to the Company's instructions until any restrictions relating to the Restricted Stock Award lapse; or (y) evidenced by a certificate, which certificate shall be held in such form and manner as determined by the Board. The terms and conditions of Restricted Stock Award Agreements may change from time to time, and the terms and conditions of separate Restricted Stock Award Agreements need not be identical, *provided, however* , that each Restricted Stock Award Agreement shall conform to (through incorporation of the provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions:

(i) **Consideration.** A Restricted Stock Award may be awarded in consideration for (A) cash, check, bank draft or money order payable to the Company; (B) past or future services actually or to be rendered to the Company or an Affiliate; or (C) any other form of legal consideration that may be acceptable to the Board in its sole discretion and permissible under applicable law.

(ii) **Vesting** . Shares of Common Stock awarded under a Restricted Stock Award Agreement may be subject to forfeiture to the Company in accordance with a vesting schedule to be determined by the Board.

(iii) **Termination of Participant's Continuous Service.** In the event a Participant's Continuous Service terminates, the Company may receive via a forfeiture condition or a repurchase right, any or all of the shares of Common Stock held by the Participant which have not vested as of the date of termination of Continuous Service under the terms of the Restricted Stock Award Agreement.

(iv) **Transferability.** Rights to acquire shares of Common Stock under the Restricted Stock Award Agreement shall be transferable by the Participant only upon such terms and conditions as are set forth in the Restricted Stock Award Agreement, as the Board shall determine in its sole discretion, so long as Common Stock awarded under the Restricted Stock Award Agreement remains subject to the terms of the Restricted Stock Award Agreement.

(b) **Restricted Stock Unit Awards.** Each Restricted Stock Unit Award Agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The terms and conditions of Restricted Stock Unit Award Agreements may change from time to time, and the terms and conditions of separate Restricted Stock Unit Award Agreements need not be identical, *provided, however*, that each Restricted Stock Unit Award Agreement shall conform to (through incorporation of the provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions:

(i) **Consideration.** At the time of grant of a Restricted Stock Unit Award, the Board will determine the consideration, if any, to be paid by the Participant upon delivery of each share of Common Stock subject to the Restricted Stock Unit Award. The consideration to be paid (if any) by the Participant for each share of Common Stock subject to a Restricted Stock Unit Award may be paid in any form of legal consideration that may be acceptable to the Board in its sole discretion and permissible under applicable law.

(ii) **Vesting.** At the time of the grant of a Restricted Stock Unit Award, the Board may impose such restrictions or conditions to the vesting of the Restricted Stock Unit Award as it, in its sole discretion, deems appropriate.

(iii) **Payment** . A Restricted Stock Unit Award may be settled by the delivery of shares of Common Stock, their cash equivalent, any combination thereof or in any other form of consideration, as determined by the Board and contained in the Restricted Stock Unit Award Agreement.

(iv) **Additional Restrictions.** At the time of the grant of a Restricted Stock Unit Award, the Board, as it deems appropriate, may impose such restrictions or conditions that delay the delivery of the shares of Common Stock (or their cash equivalent) subject to a Restricted Stock Unit Award to a time after the vesting of such Restricted Stock Unit Award.

(v) **Dividend Equivalents.** Dividend equivalents may be credited in respect of shares of Common Stock covered by a Restricted Stock Unit Award, as determined by the Board and contained in the Restricted Stock Unit Award Agreement. At the sole discretion of the Board, such dividend equivalents may be converted into additional shares of Common Stock covered by the Restricted Stock Unit Award in such manner as determined by the Board. Any additional shares covered by the Restricted Stock Unit Award credited by reason of such dividend equivalents will be subject to all the terms and conditions of the underlying Restricted Stock Unit Award Agreement to which they relate.

(vi) **Termination of Participant's Continuous Service.** Except as otherwise provided in the applicable Restricted Stock Unit Award Agreement, such portion of the Restricted Stock Unit Award that has not vested will be forfeited upon the Participant's termination of Continuous Service.

(vii) **Compliance with Section 409A of the Code.** Notwithstanding anything to the contrary set forth herein, any Restricted Stock Unit Award granted under the Plan that is not exempt from the requirements of Section 409A of the Code shall contain such provisions so that such Restricted Stock Unit Award will comply with the requirements of Section 409A of the Code. Such restrictions, if any, shall be determined by the Board and contained in the Restricted Stock Unit Award Agreement evidencing such Restricted Stock Unit Award.

(c) Stock Appreciation Rights. Each Stock Appreciation Right Agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. Stock Appreciation Rights may be granted as stand-alone Stock Awards or in tandem with other Stock Awards. The terms and conditions of Stock Appreciation Right Agreements may change from time to time, and the terms and conditions of separate Stock Appreciation Right Agreements need not be identical; *provided, however* , that each Stock Appreciation Right Agreement shall conform to (through incorporation of the provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions:

(i) **Term.** No Stock Appreciation Right shall be exercisable after the expiration of ten (10) years from the date of its grant or such shorter period specified in the Stock Appreciation Right Agreement.

(ii) **Strike Price.** Each Stock Appreciation Right will be denominated in shares of Common Stock equivalents. The strike price of each Stock Appreciation Right shall not be less than one hundred percent (100%) of the Fair Market Value of the Common Stock equivalents subject to the Stock Appreciation Right on the date of grant.

(iii) **Calculation of Appreciation.** The appreciation distribution payable on the exercise of a Stock Appreciation Right will be not greater than an amount equal to the excess of (A) the aggregate Fair Market Value (on the date of the exercise of the Stock Appreciation Right) of a number of shares of Common Stock equal to the number of shares of Common Stock equivalents in which the Participant is vested under such Stock Appreciation Right, and with respect to which the Participant is exercising the Stock

Appreciation Right on such date, over (B) the strike price that is determined by the Board on the date of grant of the Stock Appreciation Right.

(iv) **Vesting.** At the time of the grant of a Stock Appreciation Right, the Board may impose such restrictions or conditions to the vesting of such Stock Appreciation Right as it, in its sole discretion, deems appropriate.

(v) **Exercise.** To exercise any outstanding Stock Appreciation Right, the Participant must provide written notice of exercise to the Company in compliance with the provisions of the Stock Appreciation Right Agreement evidencing such Stock Appreciation Right.

(vi) **Payment** . The appreciation distribution in respect of a Stock Appreciation Right may be paid in Common Stock, in cash, in any combination of the two or in any other form of consideration, as determined by the Board and set forth in the Stock Appreciation Right Agreement evidencing such Stock Appreciation Right.

(vii) **Termination of Continuous Service.** In the event that a Participant's Continuous Service terminates, the Participant may exercise his or her Stock Appreciation Right (to the extent that the Participant was entitled to exercise such Stock Appreciation Right as of the date of termination of Continuous Service) but only within such period of time ending on the earlier of (A) the date three (3) months following the termination of the Participant's Continuous Service (or such longer or shorter period specified in the Stock Appreciation Right Agreement), or (B) the expiration of the term of the Stock Appreciation Right as set forth in the Stock Appreciation Right Agreement. If, after termination of Continuous Service, the Participant does not exercise his or her Stock Appreciation Right within the time specified herein or in the Stock Appreciation Right Agreement (as applicable), the Stock Appreciation Right shall terminate.

(viii) **Compliance with Section 409A of the Code.** Notwithstanding anything to the contrary set forth herein, any Stock Appreciation Rights granted under the Plan that are not exempt from the requirements of Section 409A of the Code shall contain such provisions so that such Stock Appreciation Right will comply with the requirements of Section 409A of the Code. Such restrictions, if any, shall be determined by the Board and contained in the Stock Appreciation Right Agreement evidencing such Stock Appreciation Right.

(d) Performance Stock Awards . A Performance Stock Award is either a Restricted Stock Award or Restricted Stock Unit Award that may be granted or may vest based upon the attainment during a Performance Period of certain Performance Goals. A Performance Stock Award may, but need not, require the completion of a specified period of Continuous Service. The length of any Performance Period, the Performance Goals to be achieved during the Performance Period, and the measure of whether and to what degree such Performance Goals have been attained shall be conclusively determined by the Committee in its sole discretion. The maximum benefit to be received by any Participant in a calendar year attributable to Performance Stock Awards described in this Section 6(d) shall not exceed the value of five hundred thousand (500,000) shares of Common Stock. In addition, to the extent permitted by applicable law and the applicable Award Agreement, the Board may determine that cash may be used in payment of Performance Stock Awards.

(e) Other Stock Awards . Other forms of Stock Awards valued in whole or in part by reference to, or otherwise based on, Common Stock may be granted either alone or in addition to Stock Awards provided for under Section 5 and the preceding provisions of this Section 6. Subject to the provisions of the Plan, the Board shall have sole and complete authority to determine the persons to whom and the time or times at which such Other Stock Awards will be granted, the number of shares of Common Stock (or the cash equivalent thereof) to be granted pursuant to such Other Stock Awards and all other terms and conditions of such Other Stock Awards.

7. Covenants of the Company.

(a) Availability of Shares. During the terms of the Stock Awards, the Company shall keep available at all times the number of shares of Common Stock required to satisfy such Stock Awards.

(b) Securities Law Compliance. The Company shall seek to obtain from each regulatory commission or agency having jurisdiction over the Plan such authority as may be required to grant Stock Awards and to issue and sell shares of Common Stock upon exercise of the Stock Awards; *provided*, *however*, that this undertaking shall not require the Company to register under the Securities Act the Plan, any Stock Award or any Common Stock issued or issuable pursuant to any such Stock Award. If, after reasonable efforts, the Company is unable to obtain from any such regulatory commission or agency the authority that counsel for the Company deems necessary for the lawful issuance and sale of Common Stock under the Plan, the Company shall be relieved from any liability for failure to issue and sell Common Stock upon exercise of such Stock Awards unless and until such authority is obtained. A Participant shall not be eligible for the grant of a Stock Award or the subsequent issuance of Common Stock pursuant to the Stock Award if such grant or issuance would be in violation of any applicable securities laws.

(c) No Obligation to Notify. The Company shall have no duty or obligation to any holder of a Stock Award to advise such holder as to the time or manner of exercising such Stock Award. Furthermore, the Company shall have no duty or obligation to warn or otherwise advise such holder of a pending termination or expiration of a Stock Award or a possible period in which the Stock Award may not be exercised. The Company has no duty or obligation to minimize the tax consequences of a Stock Award to the holder of such Stock Award.

8. Miscellaneous.

(a) Use of Proceeds. Proceeds from the sale of shares of Common Stock pursuant to Stock Awards shall constitute general funds of the Company.

(b) Corporate Action Constituting Grant of Stock Awards. Corporate action constituting a grant by the Company of a Stock Award to any Participant shall be deemed completed as of the date of such corporate action, unless otherwise determined by the Board, regardless of when the instrument, certificate, or letter evidencing the Stock Award is communicated to, or actually received or accepted by, the Participant.

(c) Stockholder Rights. No Participant shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any shares of Common Stock subject to such Stock Award unless and until (i) such Participant has satisfied all requirements for exercise of the Stock Award pursuant to its terms, and (ii) the issuance of the Common Stock pursuant to such exercise has been entered into the books and records of the Company.

(d) No Employment or Other Service Rights. Nothing in the Plan, any Stock Award Agreement or other instrument executed thereunder or in connection with any Stock Award granted pursuant thereto shall confer upon any Participant any right to continue to serve the Company or an Affiliate in the capacity in effect at the time the Stock Award was granted or shall affect the right of the Company or an Affiliate to terminate (i) the employment of an Employee with or without notice and with or without cause, (ii) the service of a Consultant pursuant to the terms of such Consultant's agreement with the Company or an Affiliate, or

(iii) the service of a Director pursuant to the Bylaws of the Company or an Affiliate, and any applicable provisions of the corporate law of the state in which the Company or the Affiliate is incorporated, as the case may be.

(e) Incentive Stock Option $100,000 Limitation. To the extent that the aggregate Fair Market Value (determined at the time of grant) of Common Stock with respect to which Incentive Stock Options are exercisable for the first time by any Optionholder during any calendar year (under all plans of the Company and any Affiliates) exceeds one hundred thousand dollars ($100,000), the Options or portions thereof that exceed such limit (according to the order in which they were granted) shall be treated as Nonstatutory Stock Options, notwithstanding any contrary provision of the applicable Option Agreement(s).

(f) Investment Assurances. The Company may require a Participant, as a condition of exercising or acquiring Common Stock under any Stock Award, (i) to give written assurances satisfactory to the Company as to the Participant's knowledge and experience in financial and business matters and/or to employ a purchaser representative reasonably satisfactory to the Company who is knowledgeable and experienced in financial and business matters and that he or she is capable of evaluating, alone or together with the purchaser representative, the merits and risks of exercising the Stock Award; and (ii) to give written assurances satisfactory to the Company stating that the Participant is acquiring Common Stock subject to the Stock Award for the Participant's own account and not with any present intention of selling or otherwise distributing the Common Stock. The foregoing requirements, and any assurances given pursuant to such requirements, shall be inoperative if (x) the issuance of the shares upon the exercise or acquisition of Common Stock under the Stock Award has been registered under a then currently effective registration statement under the Securities Act, or (y) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws. The Company may, upon advice of counsel to the Company, place legends on stock certificates issued under the Plan as such counsel deems necessary or appropriate in order to comply with applicable securities laws, including, but not limited to, legends restricting the transfer of the Common Stock.

(g) Withholding Obligations. Unless prohibited by the terms of a Stock Award Agreement, the Company may, in its sole discretion, satisfy any federal, state or local tax withholding obligation relating to a Stock Award by any of the following means (in addition to the Company's right to withhold from any compensation paid to the Participant by the Company) or by a combination of such means: (i) causing the Participant to tender a cash payment; (ii) withholding shares of Common Stock from the shares of Common Stock issued or otherwise issuable to the Participant in connection with the Stock Award; *provided, however* , that no shares of Common Stock are withheld with a value exceeding the minimum amount of tax required to be withheld by law (or such lower amount as may be necessary to avoid classification of the Stock Award as a liability for financial accounting purposes); (iii) withholding cash from a Stock Award settled in cash; (iv) withholding payment from any amounts otherwise payable to the Participant; or (v) by such other method as may be set forth in the Stock Award Agreement.

(h) Electronic Delivery . Any reference herein to a “written” agreement or document shall include any agreement or document delivered electronically or posted on the Company's intranet.

(i) Deferrals. To the extent permitted by applicable law, the Board, in its sole discretion, may determine that the delivery of Common Stock or the payment of cash, upon the exercise, vesting or settlement of all or a portion of any Stock Award may be deferred and may establish programs and procedures for deferral elections to be made by Participants. Deferrals by Participants will be made in accordance with Section 409A of the Code. Consistent with Section 409A of the Code, the Board may provide for distributions while a Participant is still an employee. The Board is authorized to make deferrals of Stock Awards and determine when, and in what annual percentages, Participants may receive payments, including lump sum payments, following the Participant's termination of employment or retirement, and implement such other terms and conditions consistent with the provisions of the Plan and in accordance with applicable law.

(j) **Compliance with Section 409A.** To the extent that the Board determines that any Stock Award granted hereunder is subject to Section 409A of the Code, the Stock Award Agreement evidencing such Stock Award shall incorporate the terms and conditions necessary to avoid the consequences specified in Section 409A(a)(1) of the Code. To the extent applicable, the Plan and Stock Award Agreements shall be interpreted in accordance with Section 409A of the Code and Department of Treasury regulations and other interpretive guidance issued thereunder, including without limitation any such regulations or other guidance that may be issued or amended after the Effective Date. Notwithstanding any provision of the Plan to the contrary, in the event that following the Effective Date the Board determines that any Stock Award may be subject to Section 409A of the Code and related Department of Treasury guidance (including such Department of Treasury guidance as may be issued after the Effective Date), the Board may adopt such amendments to the Plan and the applicable Stock Award Agreement or adopt other policies and procedures (including amendments, policies and procedures with retroactive effect), or take any other actions, that the Board determines are necessary or appropriate to (1) exempt the Stock Award from Section 409A of the Code and/or preserve the intended tax treatment of the benefits provided with respect to the Stock Award, or (2) comply with the requirements of Section 409A of the Code and related Department of Treasury guidance.

9. Adjustments upon Changes in Common Stock; Other Corporate Events.

(a) **Capitalization Adjustments** . In the event of a Capitalization Adjustment, the Board shall appropriately and proportionately adjust: (i) the class(es) and maximum number of securities subject to the Plan pursuant to Section 3(a); (ii) the class(es) and maximum number of securities that may be issued pursuant to the exercise of Incentive Stock Options pursuant to Section 3(c); (iii) the class(es) and maximum number of securities that may be awarded to any person pursuant to Section 4(c) and 6(d); and (iv) the class(es) and number of securities and price per share of stock subject to outstanding Stock Awards. The Board shall make such adjustments, and its determination shall be final, binding and conclusive.

(b) **Dissolution or Liquidation** . Except as otherwise provided in a Stock Award Agreement, in the event of a dissolution or liquidation of the Company, all outstanding Stock Awards (other than Stock Awards consisting of vested and outstanding shares of Common Stock not subject to a forfeiture condition or the Company's right of repurchase) shall terminate immediately prior to the completion of such dissolution or liquidation, and the shares of Common Stock subject to the Company's repurchase rights may be repurchased by the Company notwithstanding the fact that the holder of such Stock Award is providing Continuous Service, *provided, however,* that the Board may, in its sole discretion, cause some or all Stock Awards to become fully vested, exercisable and/or no longer subject to repurchase or forfeiture (to the extent such Stock Awards have not previously expired or terminated) before the dissolution or liquidation is completed but contingent on its completion.

(c) **Corporate Transaction.** The following provisions shall apply to Stock Awards in the event of a Corporate Transaction unless otherwise provided in the instrument evidencing the Stock Award or any other written agreement between the Company or any Affiliate and the holder of the Stock Award or unless otherwise expressly provided by the Board at the time of grant of a Stock Award. Except as otherwise stated in the Stock Award Agreement, in the event of a Corporate Transaction, then, notwithstanding any other provision of the Plan, the Board shall take one or more of the following actions with respect to Stock Awards, contingent upon the closing or completion of the Corporate Transaction:

(i) arrange for the surviving corporation or acquiring corporation (or the surviving or acquiring corporation's parent company) to assume or continue the Stock Award or to substitute a similar stock award for the Stock Award (including, but not limited to, an award to acquire the same consideration paid to the stockholders of the Company pursuant to the Corporate Transaction);

(ii) arrange for the assignment of any reacquisition or repurchase rights held by the Company in respect of Common Stock issued pursuant to the Stock Award to the surviving corporation or acquiring corporation (or the surviving or acquiring corporation's parent company)

(iii) accelerate the vesting of the Stock Award (and, if applicable, the time at which the Stock Award may be exercised) to a date prior to the effective time of such Corporate Transaction as the Board shall determine (or, if the Board shall not determine such a date, to the date that is five (5) days prior to the effective date of the Corporate Transaction), with such Stock Award terminating if not exercised (if applicable) at or prior to the effective time of the Corporate Transaction;

(iv) arrange for the lapse of any reacquisition or repurchase rights held by the Company with respect to the Stock Award;

(v) cancel or arrange for the cancellation of the Stock Award, to the extent not vested or not exercised prior to the effective time of the Corporate Transaction, in exchange for such cash consideration as the Board, in its sole discretion, may consider appropriate; and

(vi) make a payment, in such form as may be determined by the Board equal to the excess, if any, of (A) the value of the property the holder of the Stock Award would have received upon the exercise of the Stock Award, over (B) any exercise price payable by such holder in connection with such exercise.

The Board need not take the same action with respect to all Stock Awards, portions thereof, or with respect to all Participants.

(d) Change in Control. A Stock Award may be subject to additional acceleration of vesting and exercisability upon or after a Change in Control as may be provided in the Stock Award Agreement for such Stock Award or as may be provided in any other written agreement between the Company or any Affiliate and the Participant. A Stock Award may vest as to all or any portion of the shares subject to the Stock Award (i) immediately upon the occurrence of a Change in Control, whether or not such Stock Award is assumed, continued, or substituted by a surviving or acquiring entity in the Change in Control, or (ii) in the event a Participant's Continuous Service is terminated, actually or constructively, within a designated period following the occurrence of a Change in Control. In the absence of such provisions, no such acceleration shall occur.

10. Termination or Suspension of the Plan.

(a) Plan Term. The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall automatically terminate on the day before the tenth (10th) anniversary of the earlier of (i) the date the Plan is adopted by the Board, or (ii) the date the Plan is approved by the stockholders of the Company. No Stock Awards may be granted under the Plan while the Plan is suspended or after it is terminated.

(b) No Impairment of Rights. Suspension or termination of the Plan shall not impair rights and obligations under any Stock Award granted while the Plan is in effect except with the written consent of the affected Participant.

11. Effective Date of Plan.

The Plan shall become effective upon approval by the stockholders at the 2007 Annual Meeting.

12. Choice of Law.

The law of the State of Delaware shall govern all questions concerning the construction, validity and interpretation of the Plan, without regard to that state's conflict of laws rules.

13. Definitions.

As used in the Plan, the following definitions shall apply to the capitalized terms indicated below:

(a) " ***Affiliate*** " means, at the time of determination, any "parent" or "majority-owned subsidiary" of the Company, as such terms are defined in Rule 405 of the Securities Act. The Board shall have the authority to determine the time or times at which "parent" or "majority-owned subsidiary" status is determined within the foregoing definition.

(b) " ***Board*** " means the Board of Directors of the Company.

(c) " ***Capitalization Adjustment*** " means any change that is made in, or other events that occur with respect to, the Common Stock subject to the Plan or subject to any Stock Award after the Effective Date without the receipt of consideration by the Company (through merger, consolidation, reorganization, recapitalization, reincorporation, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure or other transaction not involving the receipt of consideration by the Company). Notwithstanding the foregoing, the conversion of any convertible securities of the Company shall not be treated as a transaction "without the receipt of consideration" by the Company.

(d) " ***Cause*** " means with respect to a Participant, the occurrence of any of the following events: (i) such Participant's commission of any felony or any crime involving fraud, dishonesty or moral turpitude under the laws of the United States or any state thereof; (ii) such Participant's attempted commission of, or participation in, a fraud or act of dishonesty against the Company; (iii) such Participant's intentional, material violation of any contract or agreement between the Participant and the Company or of any statutory duty owed to the Company; (iv) such Participant's unauthorized use or disclosure of the Company's confidential information or trade secrets; or (v) such Participant's gross misconduct. The determination that a termination of the Participant's Continuous Service is either for Cause or without Cause shall be made by the Company in its sole discretion. Any determination by the Company that the Continuous Service of a Participant was terminated with or without Cause for the purposes of outstanding Stock Awards held by such Participant shall have no effect upon any determination of the rights or obligations of the Company or such Participant for any other purpose.

(e) " ***Change in Control*** " means the occurrence, in a single transaction or in a series of related transactions, of any one or more of the following events:

(i) any Exchange Act Person becomes the Owner, directly or indirectly, of securities of the Company representing more than fifty percent (50%) of the combined voting power of the Company's then outstanding securities other than by virtue of a merger, consolidation or similar transaction. Notwithstanding the foregoing, a Change in Control shall not be deemed to occur (A) on account of the acquisition of securities of the Company by an investor, any affiliate thereof or any other Exchange Act Person from the Company in a transaction or series of related transactions the primary purpose of which is to obtain financing for the Company through the issuance of equity securities or (B) solely because the level of Ownership held by any Exchange Act Person (the " ***Subject Person*** ") exceeds the designated percentage threshold of the outstanding voting securities as a result of a repurchase or other acquisition of voting securities by the Company reducing the number of shares outstanding, provided that if a Change in Control would occur (but for the operation of this sentence) as a result of the acquisition of voting securities by the Company, and after such share acquisition, the Subject Person becomes the Owner of any additional voting securities that, assuming the repurchase or other acquisition had not occurred, increases the percentage of the then outstanding voting securities Owned by the Subject Person over the designated percentage threshold, then a Change in Control shall be deemed to occur;

(ii) there is consummated a merger, consolidation or similar transaction involving (directly or indirectly) the Company and, immediately after the consummation of such merger, consolidation or similar transaction, the stockholders of the Company immediately prior thereto do not Own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving Entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving Entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their Ownership of the outstanding voting securities of the Company immediately prior to such transaction;

(iii) the stockholders of the Company approve or the Board approves a plan of complete dissolution or liquidation of the Company, or a complete dissolution or liquidation of the Company shall otherwise occur, except for a liquidation into a parent corporation;

(iv) there is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its Subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its Subsidiaries to an Entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are Owned by stockholders of the Company in substantially the same proportions as their Ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition; or

(v) individuals who, on the date the Plan is adopted by the Board, are members of the Board (the " ***Incumbent Board*** ") cease for any reason to constitute at least a majority of the members of the Board; *provided, however,* that if the appointment or election (or nomination for election) of any new Board member was approved or recommended by a majority vote of the members of the Incumbent Board then still in office, such new member shall, for purposes of the Plan, be considered as a member of the Incumbent Board.

For avoidance of doubt, the term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

Notwithstanding the foregoing or any other provision of the Plan, the definition of Change in Control (or any analogous term) in an individual written agreement between the Company or any Affiliate and the Participant shall supersede the foregoing definition with respect to Stock Awards subject to such agreement; *provided, however,* that if no definition of Change in Control or any analogous term is set forth in such an individual written agreement, the foregoing definition shall apply.

(f) " ***Code*** " means the Internal Revenue Code of 1986, as amended.

(g) " ***Committee*** " means a committee of one (1) or more Directors to whom authority has been delegated by the Board in accordance with Section 2(c).

(h) " ***Common Stock*** " means the common stock of the Company.

(i) " ***Company*** " means Power Integrations, Inc., a Delaware corporation.

(j) " ***Consultant*** " means any person, including an advisor, who is (i) engaged by the Company or an Affiliate to render consulting or advisory services and is compensated for such services, or (ii) serving as a member of the board of directors of an Affiliate and is compensated for such services. However, service solely as a Director, or payment of a fee for such service, shall not cause a Director to be considered a "Consultant" for purposes of the Plan.

(k) " ***Continuous Service*** " means that the Participant's service with the Company or an Affiliate, whether as an Employee, Director or Consultant, is not interrupted or terminated. A change in the capacity in which the Participant renders service to the Company or an Affiliate as an Employee, Consultant or Director or a change in the entity for which the Participant renders such service, provided that there is no interruption or termination of the Participant's service with the Company or an Affiliate, shall not terminate a Participant's Continuous Service; *provided, however* , if the Entity for which a Participant is rendering services ceases to qualify as an "Affiliate," as determined by the Board in its sole discretion, such Participant's Continuous Service shall be considered to have terminated on the date such Entity ceases to qualify as an Affiliate. To the extent permitted by law, the Board or the chief executive officer of the Company, in that party's sole discretion, may determine whether Continuous Service shall be considered interrupted in the case of: (i) any leave of absence approved by the Board or the chief executive officer of the Company, including sick leave, military leave or any other personal leave; or (ii) transfers between the Company, an Affiliate, or their successors. Notwithstanding the foregoing, a leave of absence shall be treated as Continuous Service for purposes of vesting in a Stock Award only to such extent as may be provided in the Company's leave of absence policy, in the written terms of any leave of absence agreement or policy applicable to the Participant, or as otherwise required by law.

(l) " ***Corporate Transaction*** " means an Ownership Change Event or a series of related Ownership Change Events (collectively, the " ***Transaction*** ") wherein the stockholders of the Company immediately before the Transaction do not retain immediately after the Transaction, in substantially the same proportions as their ownership of shares of the Company's voting stock immediately before the Transaction, direct or indirect beneficial ownership of more than fifty percent (50%) of the total combined voting power of the outstanding voting stock of the Company or the corporation or corporations to which the assets of the Company were transferred (the " ***Transferee Corporation(s)*** "), as the case may be. For purposes of the preceding sentence, indirect beneficial ownership shall include, without limitation, an interest resulting from ownership of the voting stock of one or more corporations which, as a result of the Transaction, own the Company or the Transferee Corporation(s), as the case may be, either directly or through one or more subsidiary corporations. The Board shall have the right to determine whether multiple sales or exchanges of the voting stock of the Company or multiple Ownership Change Events are related, and its determination shall be final, binding and conclusive.

(m) " ***Covered Employee*** " means the chief executive officer and the three (3) other highest compensated officers of the Company (except the chief financial officer) for whom total compensation is required to be reported to stockholders under the Exchange Act, as determined for purposes of Section 162(m) of the Code.

(n) " ***Director*** " means a member of the Board.

(o) “ ***Disability*** ” means, with respect to a Participant, the inability of such Participant to engage in any substantially gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve (12) months, as provided in Section 22(e)(3) and 409A(a)(2)(c)(i) of the Code, and shall be determined by the Board on the basis of such medical evidence as the Board deems warranted under the circumstances.

(p) “ ***Effective Date*** ” means the effective date of the Plan as specified in Section 11.

(q) “ ***Employee*** ” means any person employed by the Company or an Affiliate. However, service solely as a Director, or payment of a fee for such services, shall not cause a Director to be considered an “Employee” for purposes of the Plan.

(r) “ ***Entity*** ” means a corporation, partnership, limited liability company or other entity.

(s) “ ***Exchange Act*** ” means the Securities Exchange Act of 1934, as amended.

(t) “ ***Exchange Act Person*** ” means any natural person, Entity or “group” (within the meaning of Section 13(d) or 14(d) of the Exchange Act), except that “Exchange Act Person” shall not include (i) the Company or any Subsidiary of the Company, (ii) any employee benefit plan of the Company or any Subsidiary of the Company or any trustee or other fiduciary holding securities under an employee benefit plan of the Company or any Subsidiary of the Company, (iii) an underwriter temporarily holding securities pursuant to an offering of such securities, (iv) an Entity Owned, directly or indirectly, by the stockholders of the Company in substantially the same proportions as their Ownership of stock of the Company; or (v) any natural person, Entity or “group” (within the meaning of Section 13(d) or 14(d) of the Exchange Act) that, as of the Effective Date, is the Owner, directly or indirectly, of securities of the Company representing more than fifty percent (50%) of the combined voting power of the Company's then outstanding securities.

(u) “ ***Fair Market Value*** ” means, as of any date, the value of the Common Stock determined as follows:

(i) If the Common Stock is listed on any established stock exchange or traded on any market system, the Fair Market Value of a share of Common Stock shall be the closing sales price for such stock (or the closing bid if no sales were reported) as quoted on such exchange or market (or the exchange or market with the greatest volume of trading in the Common Stock) on the date in question, as reported in *The Wall Street Journal* or such other source as the Board deems reliable. Unless otherwise provided by the Board, if there is no closing sales price (or closing bid if no sales were reported) for the Common Stock on the date in question, then the Fair Market Value shall be the closing sales price (or closing bid if no sales were reported) on the last preceding date for which such quotation exists.

(ii) In the absence of such markets for the Common Stock, the Fair Market Value shall be determined by the Board in good faith and in a manner that complies with Section 409A of the Code.

(v) “ ***Incentive Stock Option*** ” means an Option that qualifies as an “incentive stock option” within the meaning of Section 422 of the Code and the regulations promulgated thereunder.

(w) “ ***Non-Employee Director*** ” means a Director who either (i) is not a current employee or officer of the Company or an Affiliate, does not receive compensation, either directly or indirectly, from the Company or an Affiliate for services rendered as a consultant or in any capacity other than as a Director (except for an amount as to which disclosure would not be required under Item 404(a) of Regulation S-K promulgated pursuant to the Securities Act (" ***Regulation S-K*** ")), does not possess an interest in any other transaction for which disclosure would be required under Item 404(a) of Regulation S-K, and is not engaged in a business relationship for which disclosure would be required pursuant to Item 404(b) of Regulation S-K; or (ii) is otherwise considered a "non-employee director" for purposes of Rule 16b-3.

(x) " ***Nonstatutory Stock Option*** " means an Option that does not qualify as an Incentive Stock Option.

(y) " ***Officer*** " means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

(z) " ***Option*** " means an Incentive Stock Option or a Nonstatutory Stock Option to purchase shares of Common Stock granted pursuant to the Plan.

(aa) " ***Option Agreement*** " means a written agreement between the Company and an Optionholder evidencing the terms and conditions of an Option grant. Each Option Agreement shall be subject to the terms and conditions of the Plan.

(bb) " ***Optionholder*** " means a person to whom an Option is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Option.

(cc) " ***Original Plan*** " means the Company's 1997 Stock Option Plan as in effect immediately prior to the Effective Date.

(dd) " ***Other Stock Award*** " means an award based in whole or in part by reference to the Common Stock which is granted pursuant to the terms and conditions of Section 6(d).

(ee) " ***Other Stock Award Agreement*** " means a written agreement between the Company and a holder of an Other Stock Award evidencing the terms and conditions of an Other Stock Award grant. Each Other Stock Award Agreement shall be subject to the terms and conditions of the Plan.

(ff) " ***Outside Director*** " means a Director who either (i) is not a current employee of the Company or an "affiliated corporation" (within the meaning of Treasury Regulations promulgated under Section 162(m) of the Code), is not a former employee of the Company or an "affiliated corporation" who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year, has not been an officer of the Company or an "affiliated corporation," and does not receive remuneration from the Company or an "affiliated corporation," either directly or indirectly, in any capacity other than as a Director, or (ii) is otherwise considered an "outside director" for purposes of Section 162(m) of the Code.

(gg) " ***Own*** ," " ***Owned*** ," " ***Owner*** ," " ***Ownership*** " A person or Entity shall be deemed to "Own," to have "Owned," to be the "Owner" of, or to have acquired "Ownership" of securities if such person or Entity, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting power, which includes the power to vote or to direct the voting, with respect to such securities.

(hh) " ***Ownership Change Event*** " shall be deemed to have occurred if any of the following occurs with respect to the Company: (i) the direct or indirect sale or exchange in a single or series of related transactions by the stockholders of the Company of more than fifty percent (50%) of the voting stock of the Company; (ii) a merger or consolidation in which the Company is a party; (iii) the sale, exchange, or transfer of all or substantially all of the assets of the Company; or (iv) a liquidation or dissolution of the Company.

(ii) " ***Participant*** " means a person to whom a Stock Award is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Stock Award.

(jj) " ***Performance Criteria*** " means the one or more criteria that the Board shall select for purposes of establishing the Performance Goals for a Performance Period. The Performance Criteria that shall be used to establish such Performance Goals may be based on any one of, or combination of, the following: (i) earnings per share; (ii) earnings before interest, taxes and depreciation; (iii) earnings before interest, taxes, depreciation and amortization (EBITDA); (iv) total stockholder return; (v) return on equity; (vi) return on assets, investment, or capital employed; (vii) operating margin; (viii) gross margin; (ix) operating income; (x) net income (before or after taxes); (xi) net operating income; (xii) net operating income after tax; (xiii) pre- and after-tax income; (xiv) pre-tax profit; (xv) operating cash flow; (xvi) sales or revenue targets; (xvii) orders and revenue; (xviii) increases in revenue or product revenue; (xix) expenses and cost reduction goals; (xx) improvement in or attainment of expense levels; (xxi) improvement in or attainment of working capital levels; (xxii) economic value added (or an equivalent metric); (xxiii) market share; (xxiv) cash flow; (xxv) cash flow per share; (xxvi) share price performance; (xxvii) debt reduction; (xxviii) implementation or completion of projects or processes; (xxix) customer satisfaction; (xxx) stockholders' equity; (xxxi) quality measures; and (xxxii) to the extent that a Stock Award is not intended to comply with Section 162(m) of the Code, other measures of performance selected by the Board. Partial achievement of the specified criteria may result in the payment or vesting corresponding to the degree of achievement as specified in the Stock Award Agreement. The Board shall, in its sole discretion, define the manner of calculating the Performance Criteria it selects to use for such Performance Period.

(kk) " ***Performance Goals*** " means, for a Performance Period, the one or more goals established by the Board for the Performance Period based upon the satisfaction of the Performance Criteria. Performance Goals may be based on a Company-wide basis, with respect to one or more business units, divisions, Affiliates, or business segments, and in either absolute terms or relative to the performance of one or more comparable companies or the performance of one or more relevant indices. At the time of the grant of any Stock Award, the Board is authorized to determine whether, when calculating the attainment of Performance Goals for a Performance Period: (i) to exclude restructuring and/or other nonrecurring charges; (ii) to exclude exchange rate effects, as applicable, for non-U.S. dollar denominated net sales and operating earnings; (iii) to exclude the effects of changes to generally accepted accounting standards required by the Financial Accounting Standards Board; (iv) to exclude the effects of any statutory adjustments to corporate tax rates; and (v) to exclude the effects of any "extraordinary items" as determined under generally accepted accounting principles. In addition, the Board retains the discretion to reduce or eliminate the compensation or economic benefit due upon attainment of Performance Goals.

(ll) " ***Performance Period*** " means one or more periods of time, which may be of varying and overlapping duration, as the Committee may select, over which the attainment of one or more Performance Goals will be measured for the purpose of determining a Participant's right to and the payment of a Performance Stock Award.

(mm) " ***Performance Stock Award*** " means an award of shares of Common Stock which is granted pursuant to the terms and conditions of Section 6(d).

(nn) " ***Plan*** " means this Power Integrations, Inc. 2007 Equity Incentive Plan.

(oo) " ***Restricted Stock Award*** " means an award of shares of Common Stock which is granted pursuant to the terms and conditions of Section 6(a).

(pp) “ ***Restricted Stock Award Agreement*** ” means a written agreement between the Company and a holder of a Restricted Stock Award evidencing the terms and conditions of a Restricted Stock Award. Each Restricted Stock Award Agreement shall be subject to the terms and conditions of the Plan.

(qq) “ ***Restricted Stock Unit Award*** ” means a right to receive shares of Common Stock which is granted pursuant to the terms and conditions of Section 6(b).

(rr) “ ***Restricted Stock Unit Award Agreement*** ” means a written agreement between the Company and a holder of a Restricted Stock Unit Award evidencing the terms and conditions of a Restricted Stock Unit Award grant. Each Restricted Stock Unit Award Agreement shall be subject to the terms and conditions of the Plan.

(ss) “ ***Rule 16b-3*** ” means Rule 16b-3 promulgated under the Exchange Act or any successor to Rule 16b-3, as in effect from time to time.

(tt) “ ***Securities Act*** ” means the Securities Act of 1933, as amended.

(uu) “ ***Stock Appreciation Right*** ” means a right to receive the appreciation on Common Stock that is granted pursuant to the terms and conditions of Section 6(c).

(vv) “ ***Stock Appreciation Right Agreement*** ” means a written agreement between the Company and a holder of a Stock Appreciation Right evidencing the terms and conditions of a Stock Appreciation Right grant. Each Stock Appreciation Right Agreement shall be subject to the terms and conditions of the Plan.

(ww) “ ***Stock Award*** ” means any right to receive Common Stock granted under the Plan, including an Option, a Restricted Stock Award, a Restricted Stock Unit Award, a Stock Appreciation Right, a Performance Stock Award, or an Other Stock Award.

(xx) “ ***Stock Award Agreement*** ” means a written agreement between the Company and a Participant evidencing the terms and conditions of a Stock Award grant. Each Stock Award Agreement shall be subject to the terms and conditions of the Plan.

(yy) “ ***Subsidiary*** ” means, with respect to the Company, (i) any corporation of which more than fifty percent (50%) of the outstanding capital stock having ordinary voting power to elect a majority of the board of directors of such corporation (irrespective of whether, at the time, stock of any other class or classes of such corporation shall have or might have voting power by reason of the happening of any contingency) is at the time, directly or indirectly, Owned by the Company, and (ii) any partnership, limited liability company or other entity in which the Company has a direct or indirect interest (whether in the form of voting or participation in profits or capital contribution) of more than fifty percent (50%) .

(zz) “ ***Ten Percent Stockholder*** ” means a person who Owns (or is deemed to Own pursuant to Section 424(d) of the Code) stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or any Affiliate.

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Balu Balakrishnan certify that:

1. I have reviewed this Form 10-Q of Power Integrations, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

    (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 6, 2012

By: /s/ BALU BALAKRISHNAN
Balu Balakrishnan
Chief Executive Officer

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Sandeep Nayyar, certify that:

1. I have reviewed this Form 10-Q of Power Integrations, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 6, 2012

By: /s/ SANDEEP NAYYAR

Sandeep Nayyar
Chief Financial Officer

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Power Integrations, Inc. (the "Company") on Form 10-Q for the quarter ended June 30, 2012 , as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Balu Balakrishnan, Chief Executive Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), certify to the best of my knowledge that:

(1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 6, 2012

By: /s/ BALU BALAKRISHNAN
Balu Balakrishnan
Chief Executive Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.

Exhibit 32.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Power Integrations, Inc. (the “Company”) on Form 10-Q for the quarter ended June 30, 2012 , as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Sandeep Nayyar, Chief Financial Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (“Section 906”), certify to the best of my knowledge that:

(1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 6, 2012

By: /s/ SANDEEP NAYYAR
Sandeep Nayyar
Chief Financial Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.