





Table of Contents

POWER INTEGRATIONS, INC.  
TABLE OF CONTENTS

|                                      | Page   |
|--------------------------------------|--|
| <u>PART I. FINANCIAL INFORMATION</u> |  |
| Item 1.                              | <u>Financial Statements</u>  |
|                                      | <u>Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015</u> 4                                      |
|                                      | <u>Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2016 and 2015</u> 5               |
|                                      | <u>Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015</u> 6 |
|                                      | <u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015</u> 7                     |
|                                      | <u>Notes to Unaudited Condensed Consolidated Financial Statements</u> 8  |
| Item 2.                              | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 24                                    |
| Item 3.                              | <u>Quantitative and Qualitative Disclosures About Market Risk</u> 31   |
| Item 4.                              | <u>Controls and Procedures</u> 32  |
| <u>PART II. OTHER INFORMATION</u>    |  |
| Item 1.                              | <u>Legal Proceedings</u> 33  |
| Item 1A.                             | <u>Risk Factors</u> 33   |
| Item 5.                              | <u>Other Information</u> 33  |
| Item 6.                              | <u>Exhibits</u> 34   |
|                                      | <u>SIGNATURES</u> 35   |

Table of Contents

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”, “if”, “future”, “intend”, “plan”, “estimate”, “potential”, “target”, “seek” or “continue” and similar 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 the caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015, and in 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, but not limited to: 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; if demand for our products declines in our major end markets, our net revenues will decrease; 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 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; 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.

Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## POWER INTEGRATIONS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

| (In thousands)   | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| <b>CURRENT ASSETS:</b>   |                       |                      |
| Cash and cash equivalents  | \$ 95,890             | \$ 90,092            |
| Short-term marketable securities   | 130,673               | 83,769               |
| Accounts receivable, net of allowances of \$621 and \$318 in 2016 and 2015, respectively | 14,679                | 7,818                |
| Inventories  | 49,941                | 51,934               |
| Prepaid expenses and other current assets  | 7,372                 | 6,790                |
| Total current assets   | 298,555               | 240,403              |
| PROPERTY AND EQUIPMENT, net  | 94,433                | 99,381               |
| INTANGIBLE ASSETS, net   | 33,114                | 38,165               |
| GOODWILL   | 91,849                | 91,849               |
| DEFERRED TAX ASSETS  | 11,064                | 11,843               |
| OTHER ASSETS   | 6,273                 | 5,896                |
| Total assets   | \$ 535,288            | \$ 487,537           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                       |                      |
| <b>CURRENT LIABILITIES:</b>  |                       |                      |
| Accounts payable   | \$ 30,117             | \$ 21,660            |
| Accrued payroll and related expenses   | 9,011                 | 9,327                |
| Taxes payable  | 251                   | 3,620                |
| Deferred income on sales to distributors   | 16,334                | 15,101               |
| Other accrued liabilities  | 3,427                 | 2,285                |
| Total current liabilities  | 59,140                | 51,993               |
| LONG-TERM INCOME TAXES PAYABLE   | 2,666                 | 2,511                |
| DEFERRED TAX LIABILITIES   | 1,002                 | 1,291                |
| OTHER LIABILITIES  | 3,422                 | 3,123                |
| Total liabilities  | 66,230                | 58,918               |
| <b>COMMITMENTS AND CONTINGENCIES (Notes 11, 12 and 13)</b>                               |                       |                      |
| <b>STOCKHOLDERS' EQUITY:</b>   |                       |                      |
| Common stock   | 28                    | 28                   |
| Additional paid-in capital   | 162,820               | 145,366              |
| Accumulated other comprehensive loss   | (1,885                | ) (1,851 )           |
| Retained earnings  | 308,095               | 285,076              |
| Total stockholders' equity   | 469,058               | 428,619              |
| Total liabilities and stockholders' equity   | \$ 535,288            | \$ 487,537           |

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

Table of Contents

POWER INTEGRATIONS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 (Unaudited)

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| (In thousands, except per share amounts) |                    |                    |                    |                    |
| NET REVENUES                             | \$103,790          | \$88,878           | \$286,285          | \$256,700          |
| COST OF REVENUES                         | 52,597             | 44,717             | 144,508            | 126,229            |
| GROSS PROFIT                             | 51,193             | 44,161             | 141,777            | 130,471            |
| OPERATING EXPENSES:                      |                    |                    |                    |                    |
| Research and development                 | 15,906             | 13,888             | 46,544             | 43,693             |
| Sales and marketing                      | 12,029             | 11,129             | 35,453             | 35,701             |
| General and administrative               | 8,789              | 7,361              | 24,772             | 23,133             |
| Total operating expenses                 | 36,724             | 32,378             | 106,769            | 102,527            |
| INCOME FROM OPERATIONS                   | 14,469             | 11,783             | 35,008             | 27,944             |
| OTHER INCOME                             | 282                | 428                | 779                | 219                |
| INCOME BEFORE INCOME TAXES               | 14,751             | 12,211             | 35,787             | 28,163             |
| PROVISION FOR INCOME TAXES               | 586                | 698                | 1,514              | 1,717              |
| NET INCOME                               | \$14,165           | \$11,513           | \$34,273           | \$26,446           |
| EARNINGS PER SHARE:                      |                    |                    |                    |                    |
| Basic                                    | \$0.49             | \$0.40             | \$1.19             | \$0.91             |
| Diluted                                  | \$0.48             | \$0.39             | \$1.16             | \$0.89             |
| SHARES USED IN PER SHARE CALCULATION:    |                    |                    |                    |                    |
| Basic                                    | 28,972             | 28,855             | 28,834             | 29,175             |
| Diluted                                  | 29,625             | 29,298             | 29,480             | 29,856             |

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

Table of Contents

POWER INTEGRATIONS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (Unaudited)

|   | Three Months<br>Ended<br>September 30, |          | Nine Months<br>Ended<br>September 30, |          |   |
|---|--|----------|---------------------------------------|----------|---|
| (In thousands)  | 2016                                   | 2015     | 2016                                  | 2015     |   |
| NET INCOME  | \$14,165                               | \$11,513 | \$34,273                              | \$26,446 |   |
| Other comprehensive income, net of tax:   |  |          |                                       |          |   |
| Foreign currency translation adjustments, net of \$0 tax in the three and nine months ended September 30, 2016 and 2015   | (254                                   | ) 40     | (271                                  | ) 18     |   |
| Unrealized gain (loss) on marketable securities, net of \$0 tax in the three and nine months ended September 30, 2016 and 2015  | (145                                   | ) 20     | 116                                   | (17      | ) |
| Amortization of defined benefit pension items, net of tax of \$11 and \$33 in the three and nine months ended September 30, 2016, respectively, and \$18 and \$26 in the three and nine months ended September 30, 2015, respectively | 41                                     | 64       | 121                                   | 92       |   |
| Total other comprehensive income (loss)   | (358                                   | ) 124    | (34                                   | ) 93     |   |
| TOTAL COMPREHENSIVE INCOME  | \$13,807                               | \$11,637 | \$34,239                              | \$26,539 |   |

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

Table of Contents

POWER INTEGRATIONS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Unaudited)

|   | Nine Months<br>Ended<br>September 30, |                 |
|---|---------------------------------------|-----------------|
|   | 2016                                  | 2015            |
| (In thousands)  |                                       |                 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                       |                 |
| Net income  | \$34,273                              | \$26,446        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                       |                 |
| Depreciation  | 12,670                                | 12,235          |
| Amortization of intangibles   | 5,051                                 | 5,247           |
| Loss on disposal of property and equipment  | 216                                   | 270             |
| Stock-based compensation expense  | 15,217                                | 11,502          |
| Amortization of premium on marketable securities                                  | 484                                   | 809             |
| Deferred income taxes   | 490                                   | 152             |
| Increase in accounts receivable allowances  | 303                                   | 128             |
| Tax shortfall associated with employee stock plans                                | —                                     | (189 )          |
| Change in operating assets and liabilities:                                       |                                       |                 |
| Accounts receivable   | (7,164 )                              | 888             |
| Inventories   | 1,993                                 | 9,995           |
| Prepaid expenses and other assets   | (1,403 )                              | 4,278           |
| Accounts payable  | 9,037                                 | (2,035 )        |
| Taxes payable and accrued liabilities   | (2,241 )                              | (3,579 )        |
| Deferred income on sales to distributors  | 1,233                                 | 1,241           |
| Net cash provided by operating activities   | 70,159                                | 67,388          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                       |                 |
| Purchases of property and equipment   | (8,074 )                              | (7,619 )        |
| Payment for purchase of building  | —                                     | (10,389 )       |
| Payment for acquisition, net of cash acquired                                     | —                                     | (15,549 )       |
| Purchases of marketable securities  | (122,398)                             | (14,933 )       |
| Proceeds from sales and maturities of marketable securities                       | 75,128                                | 37,459          |
| Net cash used in investing activities   | (55,344 )                             | (11,031 )       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                       |                 |
| Issuance of common stock under employee stock plans                               | 8,672                                 | 6,902           |
| Repurchase of common stock  | (6,435 )                              | (53,731 )       |
| Payments of dividends to stockholders   | (11,254 )                             | (10,501 )       |
| Net cash used in financing activities   | (9,017 )                              | (57,330 )       |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                       | <b>5,798</b>                          | <b>(973 )</b>   |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>90,092</b>                         | <b>60,708</b>   |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$95,890</b>                       | <b>\$59,735</b> |
| <b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>    |                                       |                 |
| Unpaid property and equipment   | \$891                                 | \$3,216         |
| Loan applied to CamSemi purchase price  | \$—                                   | \$6,600         |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                          |                                       |                 |
| Cash paid for income taxes, net   | \$4,709                               | \$1,007         |

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





Table of Contents

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 in consolidation.

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, 2015, included in its Form 10-K filed on February 11, 2016, with the Securities and Exchange Commission.

2. SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS:

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 11, 2016, for the year ended December 31, 2015. The accounting policy information below is to aid in the understanding of the financial information disclosed.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, amending the existing accounting standards for revenue recognition. The amendments are based on the principle that revenue from the transfer of promised goods or services to customers should be recognized in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments may be applied retrospectively to each prior period presented (full retrospective method) or retrospectively with the cumulative effect recognized as of the date of initial application (modified retrospective method). The Company is required to adopt the amendments in the first quarter of 2018; early adoption is permitted beginning January 1, 2017. The Company has not yet made a final determination, but anticipates an early adoption effective on January 1, 2017, using the full retrospective method under which it would recast prior reporting periods. Under the new standards the Company expects to recognize all revenue on sales to distributors upon shipment and transfer of control (known as "sell-in" revenue recognition), rather than deferring recognition until distributors report that they have sold the products to their customers (known as "sell-through" revenue recognition). Currently, a high percentage of the Company's revenues on sales to distributors are recognized on sell-through. Because this change in methodology will cause a shift in the timing of when revenue is recognized, the Company expects that the quarterly seasonal pattern of its revenues will be affected by the new standards. Based on the Company's preliminary analysis, under the new standards net revenues for fiscal 2015 and the nine months ended September 30, 2016 would increase by less than \$1.0 million in each period.

In July 2015, the FASB amended the existing accounting standards for the measurement of inventory, ASU 2015-11, Inventory. The amendments require inventory to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The Company is required to adopt the amendments in the first quarter of 2017. The amendments should be applied prospectively with early adoption permitted as of the beginning of an interim or annual reporting period. The Company does not expect that the adoption of these amendments will have a material impact on its consolidated financial statements.

In February 2016, the FASB amended the existing accounting standards for leases, ASU 2016-02, Leases. The amendments require lessees to recognize, on the balance sheet, assets and liabilities for the rights and obligations

created by leases of greater than twelve months. The accounting by lessors will remain largely unchanged from that applied under previous U.S. GAAP. The Company is required to adopt the amendments in the first quarter of fiscal 2019, with early adoption permitted. The amendments require a modified retrospective transition approach to recognize and measure leases at the beginning of the earliest period presented. The Company is currently evaluating the impact of these amendments and the transition alternatives on its consolidated financial statements.

In March 2016, the FASB amended the existing accounting standards for stock-based compensation, ASU 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The amendments

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

impact several aspects of accounting for share-based payment transactions, including the income tax consequences, forfeitures, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The Company is required to adopt the amendments in the first quarter of 2017, with early adoption permitted. If early adoption is elected, all amendments must be adopted in the same period. The manner of application varies by the various provisions of the guidance, with certain provisions applied on a retrospective or modified retrospective approach, while others are applied prospectively. The Company is currently evaluating the impact of these amendments and the transition alternatives on its consolidated financial statements.

## 3. COMPONENTS OF THE COMPANY'S CONDENSED CONSOLIDATED BALANCE SHEETS:

## Accounts Receivable

| (In thousands)                           | September 30, December 31, |           |
|--|----------------------------|-----------|
|  | 2016                       | 2015      |
| Accounts receivable trade                | \$ 54,039                  | \$ 43,622 |
| Accrued ship and debit and rebate claims | (38,739 )                  | (35,486 ) |
| Allowance for doubtful accounts          | (621 )                     | (318 )    |
| Total                                    | \$ 14,679                  | \$ 7,818  |

## Inventories

| (In thousands)  | September 30, December 31, |           |
|-----------------|----------------------------|-----------|
|                 | 2016                       | 2015      |
| Raw materials   | \$ 15,369                  | \$ 19,090 |
| Work-in-process | 13,137                     | 12,770    |
| Finished goods  | 21,435                     | 20,074    |
| Total           | \$ 49,941                  | \$ 51,934 |

## Prepaid Expenses and Other Current Assets

| (In thousands)                 | September 30, December 31, |          |
|--------------------------------|----------------------------|----------|
|                                | 2016                       | 2015     |
| Prepaid legal fees             | \$ 1,194                   | \$ 2,023 |
| Prepaid income tax             | 689                        | 309      |
| Prepaid maintenance agreements | 1,697                      | 736      |
| Interest receivable            | 371                        | 519      |
| Advances to suppliers          | 33                         | 324      |
| Other                          | 3,388                      | 2,879    |
| Total                          | \$ 7,372                   | \$ 6,790 |

## Intangible Assets

| (In thousands)                      | September 30, 2016 |                          |          | December 31, 2015 |                          |          |
|-------------------------------------|--------------------|--------------------------|----------|-------------------|--------------------------|----------|
|                                     | Gross              | Accumulated Amortization | Net      | Gross             | Accumulated Amortization | Net      |
| Domain name                         | \$1,261            | \$ —                     | \$1,261  | \$1,261           | \$ —                     | \$1,261  |
| In-process research and development | 4,690              | —                        | 4,690    | 4,690             | —                        | 4,690    |
| Technology licenses                 | 3,000              | (3,000 )                 | —        | 3,000             | (2,925 )                 | 75       |
| Developed technology                | 33,270             | (14,516 )                | 18,754   | 33,270            | (11,670 )                | 21,600   |
| Customer relationships              | 20,030             | (11,891 )                | 8,139    | 20,030            | (10,031 )                | 9,999    |
| In-place leases                     | 660                | (390 )                   | 270      | 660               | (120 )                   | 540      |
| Total intangible assets             | \$62,911           | \$ (29,797 )             | \$33,114 | \$62,911          | \$ (24,746 )             | \$38,165 |

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The estimated future amortization expense related to finite-lived intangible assets at September 30, 2016, is as follows:

| Fiscal Year               | Estimated<br>Amortization<br>(in thousands) |
|---------------------------|---|
| 2016 (remaining 3 months) | \$ 1,611                                    |
| 2017                      | 6,084                                       |
| 2018                      | 5,152                                       |
| 2019                      | 4,753                                       |
| 2020                      | 3,528                                       |
| Thereafter                | 6,035                                       |
| Total <sup>(1)</sup>      | \$ 27,163                                   |

(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.

## Accumulated Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2016 and 2015, were as follows:

|   | Unrealized<br>Gains and<br>Losses on<br>Marketable<br>Securities |       | Defined Benefit<br>Pension Items       |           | Foreign<br>Currency<br>Items                 |       | Total                                  |           |
|---|--|-------|--|-----------|--|-------|--|-----------|
|   | Three<br>Months<br>Ended<br>September<br>30,                     | 2015  | Three Months<br>Ended<br>September 30, | 2015      | Three<br>Months<br>Ended<br>September<br>30, | 2015  | Three Months<br>Ended<br>September 30, | 2015      |
| (In thousands)  | 2016   | 2015  | 2016                                   | 2015      | 2016   | 2015  | 2016                                   | 2015      |
| Beginning balance   | \$ 164   | \$ 46 | \$(1,504)                              | \$(1,212) | \$(187)                                      | \$(1) | \$(1,527)                              | \$(1,167) |
| Other comprehensive income (loss) before reclassifications              | (145 )   | 20    | —                                      | —         | (254 )                                       | 40    | (399 )                                 | 60        |
| Amounts reclassified from accumulated other comprehensive income (loss) | —  | —     | 41                                     | (1)64     | (1)—   | —     | 41                                     | 64        |
| Net-current period other comprehensive income (loss)                    | (145 )   | 20    | 41                                     | 64        | (254 )                                       | 40    | (358 )                                 | 124       |
| Ending balance  | \$ 19  | \$ 66 | \$(1,463)                              | \$(1,148) | \$(441)                                      | \$ 39 | \$(1,885)                              | \$(1,043) |

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the three months ended September 30, 2016 and 2015.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|   | Unrealized    |      | Defined Benefit |           | Foreign       |      | Total         |           |
|---|---------------|------|-----------------|-----------|---------------|------|---------------|-----------|
|   | Gains and     |      | Pension Items   |           | Currency      |      |               |           |
|   | Losses on     |      |                 |           | Items         |      |               |           |
|   | Marketable    |      |                 |           |               |      |               |           |
|   | Securities    |      |                 |           |               |      |               |           |
|   | Nine          |      | Nine Months     |           | Nine Months   |      | Nine Months   |           |
|   | Months        |      | Ended           |           | Ended         |      | Ended         |           |
|   | Ended         |      | September 30,   |           | September 30, |      | September 30, |           |
|   | September 30, |      | September 30,   |           | September 30, |      | September 30, |           |
| (In thousands)  | 2016          | 2015 | 2016            | 2015      | 2016          | 2015 | 2016          | 2015      |
| Beginning balance   | \$(97)        | \$83 | \$(1,584)       | \$(1,240) | \$(170)       | \$21 | \$(1,851)     | \$(1,136) |
| Other comprehensive income (loss) before reclassifications              | 116           | (17) | —               | —         | (271)         | 18   | (155)         | 1         |
| Amounts reclassified from accumulated other comprehensive income (loss) | —             | —    | 121             | (1)92     | (1)—          | —    | 121           | 92        |
| Net-current period other comprehensive income (loss)                    | 116           | (17) | 121             | 92        | (271)         | 18   | (34)          | 93        |
| Ending balance  | \$19          | \$66 | \$(1,463)       | \$(1,148) | \$(441)       | \$39 | \$(1,885)     | \$(1,043) |

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the nine months ended September 30, 2016 and 2015.

## 4. FAIR VALUE MEASUREMENTS:

The FASB established 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 equivalents and short-term marketable securities 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 fair-value hierarchy of the Company's cash equivalents and marketable securities at September 30, 2016, and December 31, 2015, was as follows:

|                  | Fair Value Measurement at |            |             |
|------------------|---------------------------|------------|-------------|
|                  | September 30, 2016        |            |             |
|                  | Total                     | Quoted     |             |
|                  |                           | Active     | Significant |
| Fair             | Markets                   | Other      |             |
| Value            | for                       | Observable |             |
|                  | Identical                 | Inputs     |             |
|                  | Assets                    | (Level 2)  |             |
|                  | (Level                    |            |             |
|                  | 1)                        |            |             |
| Commercial paper | \$88,583                  | \$—        | \$88,583    |

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|                      |           |          |            |
|----------------------|-----------|----------|------------|
| Money market funds   | 5,816     | 5,816    | —          |
| Corporate securities | 83,822    | —        | 83,822     |
| Total                | \$178,221 | \$ 5,816 | \$ 172,405 |

11

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Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| (In thousands)       | Fair Value Measurement at<br>December 31, 2015 | Quoted<br>Prices in   |   |
|----------------------|--|---|---|
|                      |  | Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| Commercial paper     | \$21,194                                       | \$ —  | \$ 21,194   |
| Money market funds   | 104  | 104   | —   |
| Corporate securities | 83,769   | —   | 83,769  |
| Total                | \$105,067                                      | \$ 104  | \$ 104,963  |

The Company did not transfer any investments between Level 1 and Level 2 of the fair-value hierarchy in the nine months ended September 30, 2016, and the twelve months ended December 31, 2015.

## 5. MARKETABLE SECURITIES:

Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at September 30, 2016, were as follows:

| (In thousands)                                 | Amortized<br>Cost | Gross<br>Unrealized |          | Estimated<br>Fair<br>Market<br>Value |
|--|-------------------|---------------------|----------|--------------------------------------|
|  |                   | Gains               | Losses   |                                      |
| Investments due in less than 3 months:         |                   |                     |          |                                      |
| Commercial paper                               | \$ 1,497          | \$ —                | \$ —     | \$ 1,497                             |
| Corporate securities                           | 5,001             | —                   | —        | 5,001                                |
| Total  | 6,498             | —                   | —        | 6,498                                |
| Investments due in 4-12 months:                |                   |                     |          |                                      |
| Commercial paper                               | 45,354            | —                   | —        | 45,354                               |
| Corporate securities                           | 51,558            | 27                  | (7 )     | 51,578                               |
| Total  | 96,912            | 27                  | (7 )     | 96,932                               |
| Investments due between 12 months and 5 years: |                   |                     |          |                                      |
| Corporate securities                           | 27,244            | 41                  | (42 )    | 27,243                               |
| Total  | 27,244            | 41                  | (42 )    | 27,243                               |
| Total marketable securities                    | \$ 130,654        | \$ 68               | \$ (49 ) | \$ 130,673                           |



Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at December 31, 2015, were as follows:

| (In thousands)                                 | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Losses    | Estimated<br>Fair<br>Market<br>Value |
|--|-------------------|------------------------------|-----------|--------------------------------------|
| Investments due in less than 3 months:         |                   |                              |           |                                      |
| Corporate securities                           | \$ 38,586         | \$ 7                         | \$ (10 )  | \$ 38,583                            |
| Total  | 38,586            | 7                            | (10 )     | 38,583                               |
| Investments due in 4-12 months:                |                   |                              |           |                                      |
| Corporate securities                           | 33,654            | 1                            | (36 )     | 33,619                               |
| Total  | 33,654            | 1                            | (36 )     | 33,619                               |
| Investments due between 12 months and 5 years: |                   |                              |           |                                      |
| Corporate securities                           | 11,626            | —                            | (59 )     | 11,567                               |
| Total  | 11,626            | —                            | (59 )     | 11,567                               |
| Total marketable securities                    | \$ 83,866         | \$ 8                         | \$ (105 ) | \$ 83,769                            |

As of September 30, 2016, and December 31, 2015, the Company evaluated the nature of the investments with a loss position, which were primarily high-quality corporate securities, and determined the unrealized losses were not other-than-temporary.

**6. STOCK-BASED COMPENSATION:**

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three and nine months ended September 30, 2016, and September 30, 2015:

| (In thousands)                         | Three Months<br>Ended<br>September 30, |         | Nine Months<br>Ended<br>September 30, |          |
|--|--|---------|---------------------------------------|----------|
|  | 2016                                   | 2015    | 2016                                  | 2015     |
| Cost of revenues                       | \$348                                  | \$219   | \$731                                 | \$725    |
| Research and development               | 1,934                                  | 1,277   | 5,343                                 | 3,974    |
| Sales and marketing                    | 1,303                                  | 877     | 3,229                                 | 2,767    |
| General and administrative             | 2,204                                  | 988     | 5,914                                 | 4,036    |
| Total stock-based compensation expense | \$5,789                                | \$3,361 | \$15,217                              | \$11,502 |

Stock-based compensation expense in the three months ended September 30, 2016 was \$5.8 million (comprising approximately \$2.1 million related to performance-based (PSU) awards and long-term performance-based (PRSU) awards, \$3.4 million related to restricted stock unit (RSU) awards and \$0.3 million related to the Company's employee stock purchase plan). In the nine months ended September 30, 2016, stock compensation expense was \$15.2 million (comprising approximately \$0.2 million related to stock options, \$4.4 million related to PSUs and PRSUs, \$9.7 million related to RSUs and \$0.9 million related to the Company's employee stock purchase plan).

Stock-based compensation expense in the three months ended September 30, 2015 was \$3.4 million (comprising approximately \$0.1 million related to stock options, a reduction to expense of \$0.2 million related to PSUs and PRSUs, \$3.2 million related to RSUs and \$0.3 million related to the Company's employee stock purchase plan). In the nine months ended September 30, 2015, stock-based compensation expense was \$11.5 million (comprising approximately \$0.5 million related to stock options, \$0.6 million related to PSUs and PRSUs, \$9.5 million related to RSUs and \$0.9 million related to the Company's employee stock purchase plan).

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Stock Options

A summary of stock options outstanding as of September 30, 2016, and activity during the nine months then ended, is presented below:

|   | Shares<br>(in thousands) | Weighted-Average<br>Exercise<br>Price | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic Value<br>(in thousands) |
|---|--------------------------|---------------------------------------|---|--|
| Outstanding at January 1, 2016                    | 1,030                    | \$ 27.58                              |   |  |
| Granted   | —                        | \$ —                                  |   |  |
| Exercised   | (168 )                   | \$ 24.83                              |   |  |
| Forfeited or expired                              | —                        | \$ —                                  |   |  |
| Outstanding at September 30, 2016                 | 862                      | \$ 28.12                              | 2.72  | \$ 30,106                                      |
| Exercisable at September 30, 2016                 | 862                      | \$ 28.12                              | 2.72  | \$ 30,106                                      |
| Vested and expected to vest at September 30, 2016 | 862                      | \$ 28.12                              | 2.72  | \$ 30,106                                      |

## PSU Awards

Under the performance-based awards program, the Company grants awards in the performance year in an amount equal to twice the target number of shares to be issued if the maximum 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 target number depending on the Company's performance. The performance metrics of this program are annual targets consisting of a combination of net revenue, non-GAAP operating income and strategic goals.

As the net revenue, non-GAAP operating income and strategic goals are considered performance conditions, expense associated with these awards, net of estimated forfeitures, is recognized over the service period based on an assessment of the achievement of the performance targets. The fair value of these PSUs 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. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

In January 2016, it was determined that approximately 11,000 shares of the PSUs granted in 2015, vested in aggregate and were released to the Company's employees and executives in the first quarter of 2016.

A summary of PSUs outstanding as of September 30, 2016, and activity during the nine months then ended, is presented below:

|  | Shares<br>(in<br>thousands) | Weighted-Average<br>Grant Date Fair<br>Value Per Share | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--|-----------------------------|--|---|--|
| Outstanding at January 1, 2016                         | 11                          | \$ 52.35   |   |  |
| Granted  | 101                         | \$ 46.24   |   |  |
| Vested   | (11 )                       | \$ 52.35   |   |  |
| Forfeited  | —                           | \$ —   |   |  |
| Outstanding at September 30, 2016                      | 101                         | \$ 46.24   | 0.25  | \$ 6,340   |
| Outstanding and expected to vest at September 30, 2016 | 100                         |  | 0.25  | \$ 6,276   |

## PRSU Awards

The Company's PRSU program provides for the issuance of PRSUs which will vest based on the Company's performance measured against the PRSU program's established revenue targets. PRSUs are granted in an amount equal to twice the target number of shares to be issued if the maximum performance metrics are met. The actual number of shares the recipient receives is determined at the end of a three-year performance period based on results

achieved versus the Company's performance goals, and may range from zero to 200% of the target number. The performance goals for PRSUs granted in fiscal 2014, 2015 and 2016 were based on the Company's annual revenue growth over the respective three-year performance period.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Expense associated with these awards, net of estimated forfeitures, is recorded throughout the year depending on the number of shares expected to vest based on progress toward the performance target. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

A summary of PRSUs outstanding as of September 30, 2016, and activity during the nine months then ended, is presented below:

|  | Shares<br>(in<br>thousands) | Weighted-Average<br>Grant Date Fair<br>Value Per Share | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--|-----------------------------|--|---|--|
| Outstanding at January 1, 2016                         | 129                         | \$ 53.75   |   |  |
| Granted  | 78                          | \$ 43.26   |   |  |
| Vested   | —                           | \$ —   |   |  |
| Forfeited  | —                           | \$ —   |   |  |
| Outstanding at September 30, 2016                      | 207                         | \$ 49.78   | 1.35  | \$ 13,053  |
| Outstanding and expected to vest at September 30, 2016 | 113                         |  | 1.32  | \$ 7,114   |

## RSU Awards

A summary of RSUs outstanding as of September 30, 2016, and activity during the nine months then ended, is presented below:

|  | Shares<br>(in<br>thousands) | Weighted-<br>Average<br>Grant<br>Date Fair<br>Value Per<br>Share | Weighted-Average<br>Remaining<br>Contractual Term<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--|-----------------------------|--|---|--|
| Outstanding at January 1, 2016                         | 681                         | \$ 46.98   |   |  |
| Granted  | 322                         | \$ 46.30   |   |  |
| Vested   | (259 )                      | \$ 45.13   |   |  |
| Forfeited  | (22 )                       | \$ 47.08   |   |  |
| Outstanding at September 30, 2016                      | 722                         | \$ 47.34   | 1.47  | \$ 45,490  |
| Outstanding and expected to vest at September 30, 2016 | 670                         |  | 1.41  | \$ 42,229  |

## 7. SIGNIFICANT CUSTOMERS AND INTERNATIONAL 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

The Company's top ten customers accounted for approximately 60% and 61% of net revenues for the three and nine months ended September 30, 2016, respectively and approximately 64% and 61% of net revenues, respectively, in the corresponding periods of the previous year. 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 original equipment manufacturers (OEMs) and merchant power supply manufacturers.

In the three and nine months ended September 30, 2016, two customers, both distributors of the Company's products, accounted for more than 10% of the Company's net revenues. In the three and nine months ended September 30, 2015, one customer, also a distributor, accounted for more than 10% of net revenues. A second customer, also a distributor, accounted for more than 10% of net revenues in the three month period ended September 30, 2015.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table discloses these customers' percentage of revenues for the respective periods:

| Customer                    | Three Months Ended |                    | Nine Months Ended  |                    |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
|                             | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Avnet                       | 18%                | 20%                | 19%                | 21%                |
| Powertech Distribution Ltd. | 10%                | 11%                | 12%                | *                  |

\*Total customer percentage of revenues was less than 10%.

No other customers accounted for 10% or more of the Company's net revenues in the periods presented.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company does not have any off-balance-sheet credit exposure related to its customers. As of September 30, 2016, and December 31, 2015, 68% and 66%, respectively, of accounts receivable were concentrated with the Company's top 10 customers.

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

| Customer                     | September 30, 2016 |   | December 31, 2015 |   |
|------------------------------|--------------------|---|-------------------|---|
|                              | %                  |   | %                 |   |
| Avnet                        | 23                 | % | 20                | % |
| ATM Electronic Corporation * | 10                 | % |                   |   |

\*Total customer percentage of accounts receivable was less than 10%.

**International Sales**

The Company markets its products globally through its sales personnel and a worldwide network of independent sales representatives and distributors. As a percentage of total net revenues, international sales, which consist of sales to distributors and direct customers outside of the United States of America, based on "bill to" customer locations, comprise the following:

|                                    | Three Months Ended |                    | Nine Months Ended  |                    |
|------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                    | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Hong Kong/China                    | 53 %               | 49 %               | 51 %               | 49 %               |
| Taiwan                             | 11 %               | 15 %               | 12 %               | 14 %               |
| Korea                              | 11 %               | 10 %               | 11 %               | 10 %               |
| Western Europe (excluding Germany) | 10 %               | 11 %               | 11 %               | 11 %               |
| Japan                              | 5 %                | 4 %                | 5 %                | 5 %                |
| Germany                            | 2 %                | 3 %                | 2 %                | 3 %                |
| Other                              | 4 %                | 3 %                | 4 %                | 3 %                |
| Total foreign revenue              | 96 %               | 95 %               | 96 %               | 95 %               |

The remainder of the Company's sales is to customers within the United States of America.

**8. COMMON STOCK REPURCHASES AND CASH DIVIDENDS:**

Common Stock Repurchases

16

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Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In the nine months ended September 30, 2016, the Company purchased approximately 146,000 shares of the Company's common stock for \$6.4 million. As of September 30, 2016, the Company had approximately \$23.6 million remaining under the repurchase program, which has no expiration date. Authorization of future repurchase programs 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.

## Cash Dividends

In January 2016, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.13 per share to be paid to stockholders of record at the end of each quarter in 2016.

| (In thousands, except per share amounts) | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Dividends declared and paid              | \$3,771            | \$ 3,453           | \$11,254           | \$ 10,501          |
| Dividends declared per common share      | \$0.13             | \$ 0.12            | \$0.39             | \$ 0.36            |

## 9. EARNINGS PER SHARE:

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

A summary of the earnings per share calculation is as follows:

| (In thousands, except per share amounts)   | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Basic earnings per share:                  |                    |                    |                    |                    |
| Net income                                 | \$14,165           | \$11,513           | \$34,273           | \$26,446           |
| Weighted-average common shares             | 28,972             | 28,855             | 28,834             | 29,175             |
| Basic earnings per share                   | \$0.49             | \$0.40             | \$1.19             | \$0.91             |
| Diluted earnings per share: <sup>(1)</sup> |                    |                    |                    |                    |
| Net income                                 | \$14,165           | \$11,513           | \$34,273           | \$26,446           |
| Weighted-average common shares             | 28,972             | 28,855             | 28,834             | 29,175             |
| Effect of dilutive awards:                 |                    |                    |                    |                    |
| Employee stock plans                       | 653                | 443                | 646                | 681                |
| Diluted weighted-average common shares     | 29,625             | 29,298             | 29,480             | 29,856             |
| Diluted earnings per share                 | \$0.48             | \$0.39             | \$1.16             | \$0.89             |

The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share if the performance conditions have been satisfied as of the end of the reporting period and excludes such (1) shares when the necessary conditions have not been met. The Company has excluded the shares underlying the outstanding performance-based awards in the 2016 and 2015 calculations as the shares were not contingently issuable as of the end of the reporting periods.

In the three and nine months ended September 30, 2016, no outstanding stock awards were determined to be anti-dilutive and therefore excluded from the computation of diluted earnings per share. In the three and nine months ended September 30, 2015, 69,000 and 8,000 outstanding stock awards were determined to be anti-dilutive,



respectively, and therefore were excluded from the computation of diluted earnings per share.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**10. PROVISION FOR INCOME TAXES:**

Income-tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur.

The Company's effective tax rates for the three and nine months ended September 30, 2016, were 4.0% and 4.2%, respectively. The difference between the statutory rate of 35% and the Company's effective tax rates for the three and nine months ended September 30, 2016, was due primarily to the beneficial impact of the geographic distribution of the Company's world-wide earnings and the federal research and development tax credit which was permanently extended in December 2015. The Company's effective tax rates for the three and nine months ended September 30, 2015, were 5.7% and 6.1%, respectively. The difference between the expected statutory rate of 35% and the Company's effective tax rates for the three and nine months ended September 30, 2015, was due primarily to the beneficial impact of the geographic distribution of the Company's world-wide earnings.

As of September 30, 2016, the Company maintained a valuation allowance on its California deferred tax assets, New Jersey deferred tax assets, capital losses for federal purposes and a valuation allowance with respect to its deferred tax assets relating to tax credits in Canada.

To ensure an additional source of U.S. cash, the Company plans to repatriate a portion of its current-year offshore earnings to the U.S. for domestic operations. The Company has accordingly provided for the estimated federal and state income taxes on such portion of its current-year offshore earnings. If circumstances change and it becomes apparent that some or all of the undistributed earnings of the Company's offshore subsidiary will be remitted in the foreseeable future but income taxes have not been recognized, the Company will accrue income taxes attributable to such undistributed earnings.

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.

On July 27, 2015, in *Altera Corp. v. Commissioner*, the U.S. Tax Court issued an opinion related to the treatment of stock-based compensation expense in an intercompany cost-sharing arrangement. A final decision was issued by the Tax Court in December 2015. In February 2016, the Commissioner appealed the Tax Court decision. At this time, the U.S. Department of the Treasury has not withdrawn the requirement to include stock-based compensation expense from IRS cost-sharing regulations. The Company has reviewed this case and its impact and concluded that no adjustment to the condensed consolidated financial statements is appropriate at this time. The Company will continue to monitor ongoing developments and potential impacts to the condensed consolidated financial statements.

**11. COMMITMENTS:**

**Supplier Agreements**

Under the terms of the Company's wafer-supply agreements with Seiko Epson Corporation ("Epson"), and ROHM Lapis Semiconductor Co., Ltd. ("Lapis") the wafers purchased from these suppliers are priced in U.S. dollars; however, these agreements also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar on future purchases. Each year, the Company's management and these two suppliers review and negotiate future 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 on future purchases.

**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, Contingencies, the Company

makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

18

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Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 pulse width modulation (PWM) integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integrations 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. Fairchild 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. 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. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents, and the Court also invited briefing on enhanced damages and attorneys’ fees. Fairchild also 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. The appeal was argued on January 11, 2012, and the Federal Circuit issued a mixed ruling on March 26, 2013, affirming Fairchild’s infringement of certain claims that support the basis for the permanent injunction while reversing, vacating, and remanding the findings with respect to other claims, including the Company’s claim for damages. The Company filed a petition seeking Supreme Court review of the Federal Circuit’s ruling on damages issues, and the Supreme Court called for a response from Fairchild but ultimately declined to review the case. On remand, the Company intends to pursue its claim for financial compensation based on Fairchild’s infringement.

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 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 liquid-crystal-display (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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 (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 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; those products are expected to be addressed in the context of the parties' remand proceedings following the appeal in their earlier litigation in Delaware, and the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The 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 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 April 2012 to permit the parties to address another patent the Company 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. On March 29, 2013, the District Court denied most of the parties' post-trial motions on liability but granted the Company's motion for judgment as a matter of law finding that Fairchild infringed another of the Company's patents. On April 25, 2013, the Court denied both parties' motions regarding the unenforceability of each other's patents. The Company is challenging adverse findings on appeal; nevertheless, the Company estimates that even if the verdict on Fairchild's patent were ultimately upheld, the sales potentially impacted would amount to less than 0.5% of the Company's revenues. The Company requested an injunction preventing further infringement of its own patents by Fairchild, and Fairchild requested an injunction as well. Following a hearing on the issue in June 2014, the Court denied Fairchild's request for an injunction against the Company and granted the Company's request for an injunction against Fairchild. On January 13, 2015, the District

Court entered final judgment on the liability and validity issues discussed above, and both parties filed appeals with the Federal Circuit. Briefing on the appeal has been completed, and oral argument on the appeal took place in early July 2016, with rulings expected in the coming months. The Company is also seeking financial damages, as well as enhanced damages for willful infringement; these issues are 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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 SG and Fairchild 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 of the Company's patents now at issue in the case is unenforceable. On May 5, 2010, SG and Fairchild filed an amended answer including counterclaims accusing the Company of infringing two patents, and since that time Fairchild has withdrawn its claim for infringement of one of the patents it originally asserted against the Company but added another patent to the case over the Company's objections; the Company contests these claims vigorously. Both parties filed summary judgment motions and challenges to each other's experts' testimony, and the Court granted the Company's motion for summary judgment of non-infringement with respect to one of Fairchild's two patents. Following a trial on the remaining claims in February 2014, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of the Company's patents-in-suit, finding that SG and Fairchild infringed the Company's asserted patents and induced infringement by others, and awarding \$105.0 million in damages. The Jury also rejected Fairchild's remaining counterclaims for infringement against the Company. Fairchild challenged these rulings in post-trial motions, but the judge confirmed the jury's determinations on infringement and damages, although the Court declined to find Fairchild's infringement willful. Fairchild also pressed its unenforceability claim with respect to one of the two patents it was found to infringe in post-trial briefing, but the Court rejected Fairchild's unenforceability claim. Fairchild also requested reconsideration of the damages determinations, and the Court granted a new trial with respect to damages but none of the other issues addressed in the previous trial, with the retrial scheduled for December 2015. Thereafter, the parties completed pretrial proceedings challenging each other's experts, and the Court granted portions of each party's motions limiting the scope of expert testimony for purposes of the damages retrial, but neither party was successful in their efforts to prevent the other side's experts from testifying at trial. Following a retrial on the issue of damages in December 2015, the jury returned a verdict in the Company's favor, finding that the Company's patented technology created the basis for customer demand for the infringing Fairchild products and awarding \$139.8 million in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, 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 verdict. The Company has filed a motion requesting enhanced damages and attorney fees; Fairchild has also filed a post-trial motion to challenge the verdict. The Court held an initial hearing on the parties' post-trial motions in June 2016 and denied Fairchild's motions challenging the damages verdict in August 2016; rulings on the remaining post-trial motions are expected in the coming months.

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 asserted four Chinese patents and sought 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. In early January 2012, the Company received rulings from the PRB invalidating the majority of the claims Fairchild asserted in litigation. The Suzhou Court conducted evidentiary hearings in 2012 and issued rulings in late December 2012, finding that the Company did not infringe any of the asserted patents. Fairchild filed appeals challenging the Suzhou Court's non-infringement rulings, and the appeals



court in Nanjing held further hearings in the infringement proceedings in late 2014, but Fairchild has since dismissed its appeals, bringing the infringement proceedings to a close in the first quarter of 2015.

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 those motions was completed in October, 2011. On November 18, 2013, the Court granted the PTO's motion and transferred the case to the Federal Circuit, where additional briefing took place. Following a hearing in May 2015, the Federal Circuit ruled in the Company's favor on August 12, 2015, overturning the PTO's claim construction and remanding the case for further proceedings.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 alleged that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company 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 also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild has withdrawn its claim for infringement of one of the patents it asserted against the Company after the Company's preliminary challenge. The parties streamlined their contentions in view of the Court's pretrial rulings, and following a trial in late May and early June 2015, a jury returned a verdict finding that Fairchild infringed one of the Company's patents, that Fairchild has induced and contributed to others' infringement of the Company's patent, and that the Company induced infringement of a Fairchild patent that was previously found infringed in the 2012 trial described above, with a damages award of \$2.4 million in favor of Fairchild. Both parties filed post-trial motions and challenges to various portions of the jury verdicts, and the Court has addressed the first wave of post-trial motions, denying each side's challenges to the verdict, with rulings on Fairchild's post-trial requests for an injunction and attorneys' fees expected in the coming months. However, in parallel proceedings the Patent Office has rejected all of the asserted claims of the one Fairchild patent found infringed, determinations that Fairchild is challenging on appeal, and the Court rejected Fairchild's earlier request for an injunction based on those same claims. The Company believes it has valid defenses against the \$2.4 million award in favor of Fairchild, and therefore has not recorded a loss in its financial statements at this time.

On October 21, 2015, the Company filed a complaint for patent infringement against Fairchild Semiconductor Corporation, Fairchild Semiconductor International, Inc., and wholly-owned subsidiary Fairchild (Taiwan) Corporation (referred to collectively as "Fairchild") to address Fairchild's continued infringement of two patents Fairchild was previously found to infringe in the three District Court cases the Company brought against Fairchild discussed above. In each of the three prior cases, Fairchild was found to infringe one of the patents at issue in the latest complaint, and Fairchild's challenges to the validity of the patents were rejected during the course of the prior lawsuits as well. Fairchild has answered the Company's complaint, 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. Fairchild's answer also included counterclaims accusing the Company of infringing four patents pertaining to power conversion integrated circuit devices, including one patent the Company was found not to infringe in prior litigation. 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. No trial date has been scheduled, but further proceedings are expected over the course of the coming months.

On March 10, 2016, Silver Star Capital, LLC filed a petition with the U.S. Patent & Trademark Office (PTO) requesting that the PTO conduct an inter partes review (IPR) of the validity of the Company's U.S. Patent No. 6,212,079 (the '079 patent), which the Company has asserted against Fairchild Semiconductor in the California litigation initiated in 2004, as discussed above. The Company's '079 patent is also asserted in the Company's most recent lawsuit against Fairchild filed in October 2015, also discussed above. On March 29, 2016, ON Semiconductor Corporation filed another petition requesting inter partes review of the Company's '079 patent. On May 2, 2016, ON Semiconductor filed another petition requesting inter partes review of the validity of the Company's U.S. Patent No. 6,538,908 (the '908 patent), which the Company has also asserted against Fairchild Semiconductor in the California litigation initiated in 2004, as discussed above. In August 2016, ON Semiconductor filed ten more IPR petitions requesting review of various patents that the Company previously asserted against Fairchild as described above. The PTO denied Silver Star Capital's IPR petition but instituted IPR proceedings with respect to ON Semiconductor's petition directed to the '079 patent, with further proceedings expected in the coming months. The PTO has not acted on any of the other IPR petitions at this time but is expected to do so in the coming months. Although the validity of the Company's challenged patents has previously been confirmed in the Company's District Court litigation with Fairchild and in many cases in prior PTO reexamination proceedings as well, and though the Company intends to vigorously

defend the validity of the its patents, the outcome of the IPR proceedings is uncertain.

On April 1, 2016, Opticurrent, LLC filed a complaint against the Company in the United States District Court for the Eastern District of Texas. In its complaint, Opticurrent alleges that the Company has infringed and is infringing one patent pertaining to transistor switch devices. The Company has filed a motion to dismiss to Opticurrent's complaint, but the Court denied the motion, and further proceedings and discovery are expected over the course of the coming months, with trial currently scheduled for October 2017. The Company intends to vigorously defend itself against Opticurrent's claims.

On August 11, 2016, ON Semiconductor filed a complaint against the Company in the United States District Court for the District of Arizona. In its complaint, ON Semiconductor alleges that the Company has infringed and is infringing five patents and seeks a declaration of non-infringement with respect to three of the Company's patents that were previously asserted against

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fairchild Semiconductor. The Company has not yet answered ON Semiconductor's complaint, and no date has been set for trial, but the Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor's claims.

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.

13. 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 September 30, 2016. 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.

Table of Contents

## 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 the 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, 2015, filed with the SEC on February 11, 2016. 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 under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015, and in Part II, Item 1A—"Risk Factors" and elsewhere in this report. See also "Cautionary Note Regarding Forward-Looking Statements" at the beginning of this report.

## Overview

We design, develop and market analog and mixed-signal integrated circuits (ICs) and other electronic components and circuitry used in high-voltage power conversion. Our products are used in power converters that convert electricity from a high-voltage source (typically 48 volts or higher) to the type of power required for a specified downstream use. In most cases, this conversion entails, among other functions, converting alternating current (AC) to direct current (DC) or vice versa, reducing or increasing the voltage, and regulating the output voltage and/or current according to the customer's specifications.

A large percentage of our products are ICs used in AC-DC power supplies, which convert the high-voltage AC from a wall outlet to the low-voltage DC required by most electronic devices. Power supplies incorporating our products are used with all manner of electronic products including mobile phones, computers, entertainment and networking equipment, appliances, electronic utility meters, industrial controls and lights that utilize light-emitting diodes (LEDs) rather than incandescent or fluorescent light sources.

By virtue of our May 2012 acquisition of CT-Concept Technologie AG (Concept), we also offer insulated-gate bipolar transistor (IGBT) drivers – circuit boards containing ICs, electrical isolation components and other circuitry – used to operate arrays of high-voltage transistors. These arrays, known as IGBT modules, are used for power conversion in high-power applications (i.e., power levels ranging from a few kilowatts up to one gigawatt) such as industrial motors, solar- and wind-power systems, electric vehicles and high-voltage DC transmission systems. Our products bring a number of important benefits to the power-conversion market compared with less advanced alternatives, including reduced component count and design complexity, smaller size, higher reliability and reduced time-to-market. Our products also improve the energy efficiency of power converters, helping our customers meet the increasingly stringent efficiency standards that have been adopted around the world for many electronic products, and improving the efficacy of renewable-energy systems, electric vehicles and other high-power applications.

While the size of our addressable market fluctuates with changes in macroeconomic conditions, the market has generally exhibited only a modest growth rate over time as growth in the unit volumes of power converters 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" market. The largest proportion of our revenues comes from power-supply applications requiring 500 watts of output or less. We continue to introduce more advanced products that make our IC-based solutions more attractive in this market. We have also increased the size of our sales and field-engineering staff considerably in recent years, and we continue to expand our offerings of technical documentation and design-support tools and services 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.

Increase the penetration of our products and the size of our market opportunity in "high-power" applications. By virtue of our acquisition of Concept in 2012, we are now able to bring the benefits of integration to higher-power applications (up to approximately one gigawatt). In particular, we sell our IGBT-driver products into applications

such as industrial motor drives, renewable energy systems, DC transmission systems and electric vehicles. We have recently expanded our addressable market for high-power applications by introducing the SCALE-iDriver™ product family, which will enable us to address applications between approximately 10 kilowatts and 100 kilowatts, whereas previously our sales of high-power products were primarily for applications above 100 kilowatts.

Table of Contents

Capitalize on the growing demand for more energy-efficient electronic products and lighting technologies, and for cleaner energy and transportation technologies. We believe that energy-efficiency is becoming an increasingly important design criterion for power supplies due largely to the emergence of standards and specifications that encourage, and in some cases mandate, the design of more energy-efficient electronic products. For example, in 2008 the U.S. Department of Energy implemented mandatory federal standards governing the efficiency of external power supplies; these standards have been tightened as of early 2016. Power supplies incorporating our ICs are generally able to comply with all known efficiency specifications currently in effect, including these tighter U.S. standards. Additionally, technological advances combined with regulatory and legislative actions are resulting in the adoption of alternative lighting technologies such as LEDs. We believe this presents a significant opportunity for us because our ICs are used in driver (i.e., power-supply) circuitry for high-voltage LED lighting applications. Finally, the growing desire for less carbon-intensive sources of energy and modes of transportation represents an opportunity for us since our IGBT drivers are used in renewable-energy systems as well as electric trains and other electric vehicles.

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 are 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. Furthermore, 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 mix, end-market mix and customer mix can also cause our gross margin to fluctuate. 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 margin are impacted by the volume of units we produce.

**Recent Results**

Our net revenues were \$103.8 million and \$88.9 million in the three months ended September 30, 2016 and 2015, respectively, and \$286.3 million and \$256.7 million in the nine months ended September 30, 2016 and 2015, respectively. The increase in revenues was due primarily to higher unit sales into the communications end-market, largely as a result of the success of our InnoSwitch products in mobile-device chargers, and into the consumer market, particularly the consumer-appliance market. The increase was partially offset by lower unit sales into the computer end-market, reflecting reduced demand for power supplies for desktop computers.

Our top ten customers, including distributors that resell to original equipment manufacturers (OEMs) and merchant power supply manufacturers, accounted for 60% and 64% of our net revenues in the three months ended September 30, 2016 and 2015, respectively, and 61% in both the nine months ended September 30, 2016 and 2015. Our top customer, a distributor of our products, accounted for approximately 18% and 19% of our net revenues in the three and nine months ended September 30, 2016, respectively, and 20% and 21% in each of the three and nine months ended September 30, 2015, respectively. International sales accounted for 96% of our net revenues in each of the three and nine months ended September 30, 2016, and 95% of our net revenues in each of the three and nine months ended September 30, 2015.

Our gross margin was 49% and 50% in the three months ended September 30, 2016 and 2015, respectively, and 50% and 51% in the nine months ended September 30, 2016 and 2015, respectively. The decrease in gross margin for the three and nine months ended September 30, 2016, as compared with the same periods in the prior year was due primarily to an unfavorable change in end-market mix, with a greater percentage of revenue coming from lower-margin end markets, particularly communications.

Total operating expenses were \$36.7 million and \$32.4 million in the three months ended September 30, 2016 and 2015, respectively, and \$106.8 million and \$102.5 million in the nine months ended September 30, 2016 and 2015, respectively. The increase in operating expenses was due primarily to increased stock-based compensation expense related to annual performance-based awards (PSUs). Based on our financial performance in the first nine months of

2016 and our expectations for the remainder of the year, we expect a greater number of 2016 PSUs to vest as compared to the 2015 PSUs.



Table of Contents

## 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;
- business combinations; 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. There have been no material changes to our critical accounting policies and estimates disclosed in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates” and Note 2, Summary of Significant Accounting Policies, in each case in our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the SEC on February 11, 2016.

## Results of Operations

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

|                            | Three Months<br>Ended<br>September 30,<br>2016 |        | Nine Months<br>Ended<br>September 30,<br>2015 |        |
|----------------------------|--|--------|---|--------|
|                            | 2016   | 2015   | 2016  | 2015   |
| Net revenues               | 100.0%   | 100.0% | 100.0%  | 100.0% |
| Cost of revenues           | 50.7   | 50.3   | 50.5  | 49.2   |
| Gross profit               | 49.3   | 49.7   | 49.5  | 50.8   |
| Operating expenses:        |  |        |   |        |
| Research and development   | 15.3   | 15.6   | 16.3  | 17.0   |
| Sales and marketing        | 11.6   | 12.5   | 12.4  | 13.9   |
| General and administrative | 8.4  | 8.3    | 8.7   | 9.0    |
| Total operating expenses   | 35.3   | 36.4   | 37.4  | 39.9   |
| Income from operations     | 14.0   | 13.3   | 12.1  | 10.9   |
| Other income               | 0.2  | 0.5    | 0.3   | 0.1    |
| Income before income taxes | 14.2   | 13.7   | 12.4  | 11.0   |
| Provision for income taxes | 0.6  | 0.8    | 0.4   | 0.7    |
| Net income                 | 13.6 %   | 12.9 % | 12.0 %  | 10.3 % |

## Comparison of the Three and Nine Months Ended September 30, 2016 and 2015

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three and nine months ended September 30, 2016, were \$103.8 million and \$286.3 million, respectively, and \$88.9 million and \$256.7 million, respectively, for the corresponding periods of 2015. The increase in revenues was due primarily to higher unit sales into the communications end-market, largely as a result of the success of our InnoSwitch products in mobile-device chargers, and into the consumer market, particularly the consumer-appliance market. The increase was partially offset by lower unit sales into the computer end-market,

reflecting reduced demand for power supplies for desktop computers.

26

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Table of Contents

Our revenue mix by end market for the three and nine month periods ended September 30, 2016, compared to the corresponding periods in 2015, was as follows:

| End Market     | Three Months Ended September 30, |      | Nine Months Ended September 30, |      |
|----------------|----------------------------------|------|---------------------------------|------|
|                | 2016                             | 2015 | 2016                            | 2015 |
| Communications | 28 %                             | 26 % | 26 %                            | 23 % |
| Computer       | 5 %                              | 7 %  | 6 %                             | 7 %  |
| Consumer       | 37 %                             | 36 % | 37 %                            | 37 % |
| Industrial     | 30 %                             | 31 % | 31 %                            | 33 % |

International sales, consisting of sales outside of the United States based on “bill to” customer locations, were \$99.8 million and \$275.2 million in the three and nine months ended September 30, 2016, respectively, and \$84.7 million and \$244.2 million, respectively, in the corresponding periods of 2015. Although power converters using our products are distributed to end markets worldwide, most are manufactured in Asia. As a result, sales to this region represented 81% and 80% of our net revenues in the three and nine months ended September 30, 2016, respectively, and 80% and 79% of our net revenues in the corresponding periods of 2015, respectively. 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 to distributors accounted for 75% of net revenues in both the three and nine months ended September 30, 2016, and 75% and 76% in the corresponding periods of 2015, respectively. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In the three and nine months ended September 30, 2016, two customers, both distributors of our products, accounted for more than 10% of our net revenues. In the three and nine months ended September 30, 2015, one of these customers accounted for more than 10% of net revenues. The second customer accounted for more than 10% of net revenues in the three month period ended September 30, 2015, but not in the nine month period ended September 30, 2015.

The following table discloses these customers’ percentage of revenues for the respective periods:

| Customer                    | Three Months Ended September 30, |      | Nine Months Ended September 30, |      |
|-----------------------------|----------------------------------|------|---------------------------------|------|
|                             | 2016                             | 2015 | 2016                            | 2015 |
| Avnet                       | 18 %                             | 20 % | 19 %                            | 21 % |
| Powertech Distribution Ltd. | 10 %                             | 11 % | 12 %                            | *    |

\*Total customer percentage of revenues was less than 10%.

No other customers accounted for 10% or more of our net revenues in these 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 contracted foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facilities, amortization of acquired intangible assets, 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 nine months ended September 30, 2016 and 2015:

| (dollars in millions) | Three Months Ended September 30, |      | Nine Months Ended September 30, |      |
|-----------------------|----------------------------------|------|---------------------------------|------|
|                       | 2016                             | 2015 | 2016                            | 2015 |

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|              |          |         |          |          |
|--------------|----------|---------|----------|----------|
| Net revenues | \$ 103.8 | \$ 88.9 | \$ 286.3 | \$ 256.7 |
| Gross profit | \$ 51.2  | \$ 44.2 | \$ 141.8 | \$ 130.5 |
| Gross margin | 49.3     | % 49.7  | % 49.5   | % 50.8   |

The decrease in gross margin for the three and nine months ended September 30, 2016, compared with the same periods in the prior year, was due primarily to an unfavorable change in end-market mix, with a greater percentage of revenues coming from lower-margin end-markets, particularly communications.

Table of Contents

Research and development expenses. Research and development (“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 technologies 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 nine months ended September 30, 2016 and 2015:

|                                    | Three Months        |        | Nine Months         |         |
|------------------------------------|---------------------|--------|---------------------|---------|
|                                    | Ended September 30, |        | Ended September 30, |         |
| (dollars in millions)              | 2016                | 2015   | 2016                | 2015    |
| Net revenues                       | \$103.8             | \$88.9 | \$286.3             | \$256.7 |
| R&D expenses                       | \$15.9              | \$13.9 | \$46.5              | \$43.7  |
| R&D expenses as a % of net revenue | 15.3 %              | 15.6 % | 16.3 %              | 17.0 %  |

R&D expenses increased in the three and nine months ended September 30, 2016, as compared to the same period in 2015 primarily due to increased stock-based compensation expense related to performance-based stock awards expected to vest as a result of our 2016 performance and expectations for the remainder of the year. The expansion of headcount in support of our product-development efforts also contributed to the increase.

Sales and marketing expenses. Sales and marketing (“S&M”) expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, amortization of intangible assets and facilities expenses, including expenses associated with our regional sales and support offices. The table below compares S&M expenses for the three and nine months ended September 30, 2016 and 2015:

|                                    | Three Months        |        | Nine Months         |         |
|------------------------------------|---------------------|--------|---------------------|---------|
|                                    | Ended September 30, |        | Ended September 30, |         |
| (dollars in millions)              | 2016                | 2015   | 2016                | 2015    |
| Net revenues                       | \$103.8             | \$88.9 | \$286.3             | \$256.7 |
| S&M expenses                       | \$12.0              | \$11.1 | \$35.5              | \$35.7  |
| S&M expenses as a % of net revenue | 11.6 %              | 12.5 % | 12.4 %              | 13.9 %  |

S&M expenses increased in the three months ended September 30, 2016, compared to the same period in 2015, due increased stock-based compensation expense related to performance-based stock awards expected to vest as a result of our 2016 performance and expectations for the remainder of the year. In addition, higher bonus and sales commissions contributed to the increase. S&M expenses were relatively flat in the nine months ended September 30, 2016, compared to the same period in 2015, as the higher stock-based compensation and sales commissions in 2016 were offset by lower salary and related expenses reflecting rationalization of headcount from our acquisition of CamSemi in 2015.

General and administrative expenses. General and administrative (“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 audit expenses. The table below compares G&A expenses for the three and nine months ended September 30, 2016 and 2015:

|                                    | Three Months        |        | Nine Months         |         |
|------------------------------------|---------------------|--------|---------------------|---------|
|                                    | Ended September 30, |        | Ended September 30, |         |
| (dollars in millions)              | 2016                | 2015   | 2016                | 2015    |
| Net revenues                       | \$103.8             | \$88.9 | \$286.3             | \$256.7 |
| G&A expenses                       | \$8.8               | \$7.4  | \$24.8              | \$23.1  |
| G&A expenses as a % of net revenue | 8.4 %               | 8.3 %  | 8.7 %               | 9.0 %   |

G&A expenses increased in the three and nine months ended September 30, 2016, compared to the same periods in 2015. The increase was due primarily to increased stock-based compensation expense related to performance-based stock awards expected to vest as a result of our 2016 performance and expectations for the remainder of the year.



Table of Contents

Other income. Other income consists primarily of interest income earned on cash and cash equivalents, marketable securities and other investments, and foreign exchange gains or losses. The table below compares other income for the three and nine months ended September 30, 2016 and 2015:

|                                    | Three Months        |        | Nine Months         |         |
|------------------------------------|---------------------|--------|---------------------|---------|
|                                    | Ended September 30, |        | Ended September 30, |         |
| (dollars in millions)              | 2016                | 2015   | 2016                | 2015    |
| Net revenues                       | \$103.8             | \$88.9 | \$286.3             | \$256.7 |
| Other income                       | \$0.3               | \$0.4  | \$0.8               | \$0.2   |
| Other income as a % of net revenue | 0.2                 | % 0.5  | % 0.3               | % 0.1   |

Other income remained relatively flat in the three months ended September 30, 2016, compared to the same period in 2015. Other income increased in the nine months ended September 30, 2016, compared to the same period in 2015 due primarily to the unfavorable impact of foreign currency movements relative to the U.S. dollar and the related loss recognized from the re-measurement of monetary foreign currency assets and liabilities of our Swiss subsidiary in 2015.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes. The table below compares income-tax expense for the three and nine months ended September 30, 2016 and 2015:

|                            | Three Months        |        | Nine Months         |        |
|----------------------------|---------------------|--------|---------------------|--------|
|                            | Ended September 30, |        | Ended September 30, |        |
| (dollars in millions)      | 2016                | 2015   | 2016                | 2015   |
| Income before income taxes | \$14.8              | \$12.2 | \$35.8              | \$28.2 |
| Provision for income taxes | \$0.6               | \$0.7  | \$1.5               | \$1.7  |
| Effective tax rate         | 4.0                 | % 5.7  | % 4.2               | % 6.1  |

Our effective tax rates for the three and nine months ended September 30, 2016, were 4.0% and 4.2%, respectively. In the three and nine months ended September 30, 2016, the effective tax rates were lower than the statutory federal income-tax rate of 35% primarily due to the beneficial impact of the geographic distribution of our world-wide earnings and the federal research and development tax credit, which was permanently extended in December 2015. In the three and nine months ended September 30, 2015, the effective tax rates were lower than the statutory federal income-tax rate of 35% primarily due to the beneficial impact of the geographic distribution of our world-wide earnings.

#### Liquidity and Capital Resources

As of September 30, 2016, we had \$226.6 million in cash, cash equivalents and short-term marketable securities, an increase of approximately \$52.7 million from \$173.9 million as of December 31, 2015. As of September 30, 2016, we had working capital, defined as current assets less current liabilities, of \$239.4 million, an increase of approximately \$51.0 million from \$188.4 million as of December 31, 2015.

On July 5, 2012, we entered into a credit agreement (the "Credit Agreement") with two banks. The Credit Agreement provides us with a \$100.0 million revolving line of credit to use for general corporate purposes with a \$20.0 million sub-limit for the issuance of standby and trade letters of credit. The Credit Agreement was amended on April 1, 2014, to extend the Credit Agreement termination date from July 5, 2015 to April 1, 2017, with all other terms of the Credit Agreement remaining the same.

On July 27, 2016, we terminated the Credit Agreement and entered into a new Credit Agreement with a bank (the "New Credit Agreement"). The New Credit Agreement provides us with a \$75.0 million revolving line of credit to use for general corporate purposes with a \$20.0 million sub-limit 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 minimum liquidity measure and a debt to earnings ratio, with which we are currently in compliance. The New Credit Agreement terminates on July 26, 2019; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of September 30, 2016,

we had no amounts outstanding under our agreement.

Operating activities generated cash of \$70.2 million in the nine months ended September 30, 2016. Net income for this period was \$34.3 million; we also incurred non-cash stock-based compensation, depreciation and amortization expenses of \$15.2 million, \$12.7 million and \$5.1 million, respectively. Sources of cash also included a \$9.0 million increase in accounts payable due primarily to the timing of payments, a \$2.0 million decrease in inventories due to increased sales and a \$1.2 million increase



Table of Contents

in deferred income on sales to distributors due to increased inventory levels at our distributors in anticipation of end-customer demand. These sources of cash were partially offset by a \$7.2 million increase in accounts receivable due to increased shipments, a \$2.2 million decrease in taxes payable due to taxes paid during the period and a \$1.4 million increase in prepaid expenses and other assets.

Operating activities generated cash of \$67.4 million in the nine months ended September 30, 2015. Net income for this period was \$26.4 million; we also incurred non-cash depreciation, amortization and stock-based compensation expenses of \$12.2 million, \$5.2 million and \$11.5 million, respectively. Significant changes in assets and liabilities included a \$10.0 million decrease in inventory due to ongoing reduction efforts and a \$4.3 million decrease in prepaid expenses and other assets due primarily to a decrease in prepaid legal fees and income tax refunds received during the period. These increases in cash were partially offset by a \$3.6 million decrease in accrued liabilities due to lower accrued professional fees and a \$2.0 million decrease in accounts payable due primarily to the timing of payments.

Our investing activities in the nine months ended September 30, 2016, resulted in a \$55.3 million net use of cash, consisting of \$47.3 million for purchases of marketable securities, net of maturities, and \$8.1 million for purchases of property and equipment, primarily production-related machinery and equipment. Our investing activities in the nine months ended September 30, 2015, resulted in a \$11.0 million net use of cash, consisting primarily of \$15.5 million in net cash paid for the acquisition of CamSemi, \$10.4 million net cash paid for a building purchase and \$7.6 million for purchases of property and equipment, primarily machinery and equipment for production. These uses of cash were partially offset by \$22.5 million of proceeds from the sale and maturity of marketable securities, net of purchases.

Our financing activities in the nine months ended September 30, 2016, resulted in a \$9.0 million net use of cash. Financing activities consisted of \$11.3 million for the payment of dividends to stockholders and \$6.4 million for the repurchase of our common stock, partially offset by proceeds of \$8.7 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. Our financing activities in the nine months ended September 30, 2015, resulted in a \$57.3 million net use of cash. Financing activities consisted primarily of \$53.7 million for the repurchase of our common stock and \$10.5 million for the payment of dividends to stockholders, partially offset by proceeds of \$6.9 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.

In January 2015, our board of directors declared four cash dividends in the amount of \$0.12 per share to be paid to stockholders of record at the end of each quarter in 2015. We paid a total of \$13.9 million in cash dividends in 2015. In January 2016, our board of directors declared four quarterly cash dividends in the amount of \$0.13 per share to be paid to stockholders of record at the end of each quarter in 2016. Dividend payouts of approximately \$3.7 million occurred on March 31, 2016 and approximately \$3.8 million occurred on each of June 30, 2016 and September 30, 2016. 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 interests of our stockholders.

In the year ended December 31, 2015, our board of directors authorized the use of \$60.0 million for repurchase of our common stock, with repurchases to be executed according to pre-defined price/volume guidelines. In the nine months ended September 30, 2016, we purchased approximately 146,000 shares for \$6.4 million. As of September 30, 2016, we had approximately \$23.6 million remaining in our repurchase program, which has no expiration date.

Authorization of future repurchase programs 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 of September 30, 2016, we had a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately \$15.1 million. A portion of the tax obligation is classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our condensed consolidated balance sheet. As of September 30, 2016, there were no material changes in our contractual commitments from those reported in our Annual Report on Form 10-K for the year ended December 31, 2015.

Our cash, cash equivalents and investment balances may change in future periods due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to future acquisitions. We expect continued sales growth in our foreign business and plan to use the earnings generated by our foreign

subsidiaries to continue to fund both the working capital and growth needs of our foreign entities, along with providing funding for any future foreign acquisitions. We do not provide for U.S. taxes on our undistributed earnings of foreign subsidiaries that we intend to invest indefinitely outside the U.S., unless such taxes are otherwise required under U.S. tax law. Beginning in 2013, we determined that a portion of our foreign subsidiaries' current and future earnings may be remitted prospectively to the U.S. for domestic cash flow purposes and, accordingly, provided for the related U.S. taxes in our condensed consolidated financial statements. Currently the

## Table of Contents

majority of our cash and marketable securities are held in the U.S. If we change our intent to invest our undistributed earnings outside the U.S. indefinitely or if a greater amount of undistributed earnings are needed for U.S. operations than previously anticipated and for which U.S. taxes have not been recorded, we would be required to accrue or pay U.S. taxes (subject to an adjustment for foreign tax credits, where applicable) and withholding taxes payable to various foreign countries on some or all of these undistributed earnings. As of December 31, 2015, we had undistributed earnings of foreign subsidiaries that are indefinitely invested outside of the U.S. of approximately \$222.0 million.

If our operating results deteriorate during the remainder of 2016 as a result of a decrease in customer demand, pricing pressure, or other factors, 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.

### Off-Balance-Sheet Arrangements

As of September 30, 2016, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

### Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, amending the existing accounting standards for revenue recognition. The amendments are based on the principle that revenue from the transfer of promised goods or services to customers should be recognized in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments may be applied retrospectively to each prior period presented (full retrospective method) or retrospectively with the cumulative effect recognized as of the date of initial application (modified retrospective method). The Company is required to adopt the amendments in the first quarter of 2018; early adoption is permitted beginning January 1, 2017. The Company has not yet made a final determination, but anticipates an early adoption effective on January 1, 2017, using the full retrospective method under which it would recast prior reporting periods. Under the new standards the Company expects to recognize all revenue on sales to distributors upon shipment and transfer of control (known as "sell-in" revenue recognition), rather than deferring recognition until distributors report that they have sold the products to their customers (known as "sell-through" revenue recognition). Currently, a high percentage of the Company's revenues on sales to distributors are recognized on sell-through. Because this change in methodology will cause a shift in the timing of when revenue is recognized, the Company expects that the quarterly seasonal pattern of its revenues will be affected by the new standards. Refer to Item 5, Other Information for additional information on the potential impact of adoption.

Information with respect to other recent accounting pronouncements may be found in Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in our Notes to Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

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

There has not been a material change in our exposure to foreign currency exchange and interest rate risks from that described in our Annual Report on Form 10-K for the year ended December 31, 2015.

**Interest Rate Risk.** Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months at the date of purchase are classified as short-term investments. We generally hold securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments, and therefore we classify our

investment portfolio as available-for-sale. 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. Our portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. At September 30, 2016, and December 31, 2015, we held primarily cash equivalents and short-term investments with fixed interest rates.

## Table of Contents

Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. We monitor our investments per our above-mentioned investment policy; therefore, if market interest rates were to increase or decrease by 10% from interest rates as of September 30, 2016, or December 31, 2015, 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 5, Marketable Securities, in our Notes to Unaudited Condensed Consolidated Financial Statements, for a tabular presentation of our available-for-sale investments and the expected maturity dates.

**Foreign Currency Exchange Risk.** As of September 30, 2016, our primary transactional currency was U.S. dollars; in addition, we hold cash in Swiss francs and euro. We maintain cash denominated in Swiss francs and euro to fund the operations of our Swiss subsidiary. The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc and euro is recorded in other income in our condensed consolidated statements of income.

We have sales offices in various other foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. 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. From time to time we may enter into foreign currency hedging contracts to hedge certain foreign currency transactions. As of September 30, 2016, and December 31, 2015, we did not have an open foreign currency hedge program utilizing foreign currency forward exchange contracts.

Two of our major suppliers, Epson and 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 on future purchases. Each year, our management and these two suppliers review and negotiate future 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 us and each of these suppliers on future purchases.

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 1.0%; 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**

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2016, 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.

Table of Contents

## 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 Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

## ITEM 1A. RISK FACTORS

As of the date of this filing, the risk factors have not changed substantively from those disclosed in Part 1 Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2015, which risk factors are incorporated by reference in this report.

## ITEM 5. OTHER INFORMATION

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, amending the existing accounting standards for revenue recognition. The amendments are based on the principle that revenue from the transfer of promised goods or services to customers should be recognized in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments may be applied retrospectively to each prior period presented (full retrospective method) or retrospectively with the cumulative effect recognized as of the date of initial application (modified retrospective method). The Company is required to adopt the amendments in the first quarter of 2018; early adoption is permitted beginning January 1, 2017. The Company has not yet made a final determination, but anticipates an early adoption effective on January 1, 2017, using the full retrospective method under which it would recast prior reporting periods.

Under the new standards the Company expects to recognize all revenue on sales to distributors upon shipment and transfer of control (known as "sell-in" revenue recognition), rather than deferring recognition until distributors report that they have sold the products to their customers (known as "sell-through" revenue recognition). Currently, a high percentage of the Company's revenues on sales to distributors are recognized on sell-through. Because this change in methodology will cause a shift in the timing of when revenue is recognized, the Company expects that the quarterly seasonal pattern of its revenues will be affected by the new standards.

The following is preliminary analysis of the impact of the standard on historically presented interim and annual net revenues and cost of revenues for 2016 and 2015:

Fiscal 2016 (Unaudited)

| (In millions)      | Net Revenues |                     | Cost of Revenues |                     |
|--------------------|--------------|---------------------|------------------|---------------------|
|                    | As Reported  | Under New Standards | As Reported      | Under New Standards |
| First Quarter      | \$85.3       | \$ 88.0             | \$42.4           | \$ 43.5             |
| Second Quarter     | 97.2         | 97.6                | 49.5             | 49.8                |
| Third Quarter      | 103.8        | 101.6               | 52.6             | 51.8                |
| Total year to date | \$286.3      | \$ 287.2            | \$144.5          | \$ 145.1            |

Table of Contents

## Fiscal 2015 (Unaudited)

| (In millions)  | Net Revenues |                     | Cost of Revenues |                     |
|----------------|--------------|---------------------|------------------|---------------------|
|                | As Reported  | Under New Standards | As Reported      | Under New Standards |
| First Quarter  | \$82.6       | \$ 86.6             | \$40.3           | \$ 42.8             |
| Second Quarter | 85.2         | 84.4                | 41.2             | 40.6                |
| Third Quarter  | 88.9         | 88.1                | 44.7             | 44.4                |
| Fourth Quarter | 87.3         | 85.5                | 44.4             | 43.5                |
| Total          | \$344.0      | \$ 344.6            | \$170.6          | \$ 171.3            |

## 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.



Table of Contents

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: November 1,  
2016

By: /s/ SANDEEP NAYYAR

Sandeep Nayyar  
Chief Financial Officer (Duly Authorized Officer, Principal Financial Officer and  
Principal Accounting Officer)

Table of Contents

## INDEX TO EXHIBITS

| EXHIBIT<br>NUMBER | Exhibit Description  | Incorporation by Reference |                |                               | Filing<br>Date | Filed<br>Herewith |
|-------------------|--|----------------------------|----------------|-------------------------------|----------------|-------------------|
|                   |  | Form                       | File<br>Number | Exhibit/Appendix<br>Reference |                |                   |
| 3.1               | Restated Certificate of Incorporation.   | 10-K                       | 000-23441      | 3.1                           | 2/29/2012      |                   |
| 3.2               | Amended and Restated Bylaws.   | 8-K                        | 000-23441      | 3.1                           | 4/26/2013      |                   |
| 4.1               | Reference is made to Exhibits 3.1 to 3.2.  |                            |                |                               |                |                   |
| 10.1†             | Amendment Number Seven to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and OKI Semiconductor Co., Ltd., effective as of August 8, 2016 |                            |                |                               |                | X                 |
| 10.2              | Power Integrations, Inc. 2016 Incentive Award Plan   | DEF14A                     | 000-23441      | Appendix A                    |                |                   |
| 10.3              | Power Integrations, Inc. 1997 Employee Stock Purchase Plan, as amended   | DEF14A                     | 000-23441      | Appendix B                    |                |                   |
| 31.1              | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |                            |                |                               |                | X                 |
| 31.2              | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |                            |                |                               |                | X                 |
| 32.1**            | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |                            |                |                               |                | X                 |
| 32.2**            | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |                            |                |                               |                | X                 |
| 101.INS           | XBRL Instance Document   |                            |                |                               |                | X                 |
| 101.SCH           | XBRL Taxonomy Extension Schema Document  |                            |                |                               |                | X                 |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase Document  |                            |                |                               |                | X                 |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase Document   |                            |                |                               |                | X                 |

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|         |  |   |
|---------|--|---|
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        | X |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | X |

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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This Exhibit has been filed separately with the Commission pursuant to an application for confidential treatment. The confidential portions of this Exhibit have been omitted and are marked by an asterisk.

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.