POWER INTEGRATIONS INC
Form 10-K/A
August 14, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K/A

(Amendment No. 1)

(Mark One)

x **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2006**

or

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

Commission File Number 0-23441

POWER INTEGRATIONS, INC.

(Exact name of registrant as specified in its charter)

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

5245 Hellyer Avenue, San Jose, California 95138-1002

(Address of principal executive offices) (Zip code)

(408) 414-9200

(Registrant s telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value per share	**The Nasdaq Stock Market, Inc.**

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

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

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

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The aggregate market value of registrant s voting and non-voting common stock held by nonaffiliates of registrant on June 30, 2006, the last business day of the registrant s most recently completed second fiscal quarter, was approximately $333,759,321, based upon the closing sale price of the common stock as reported on The NASDAQ Stock Market, now The NASDAQ Global Market. Shares of common stock held by each officer, director and holder of 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

Outstanding shares of registrant s common stock, $0.001 par value, as of June 30, 2007: 28,682,475.

Table of Contents

EXPLANATORY NOTE

We are filing this amendment to our Annual Report on Form 10-K, originally filed with the Securities and Exchange Commission on August 8, 2007 (the Form 10-K), solely for the purpose of (1) amending Item 15 solely for the purpose of (a) correcting the Report of KPMG LLP and (b) adding a Note 14 to the financial statements (this filing makes no other changes to the financial statements originally filed in the December 31, 2006 Form 10-K), and (2) amending the Exhibit List to add Exhibits 23.1 and 23.2 and to file those exhibits. In addition, since the filing of the Form 10-K, Power Integrations, Inc. has become current in its filings under the Securities Exchange Act of 1934, and its common stock has resumed registration under Section 12(b) of the Securities Exchange Act of 1934, as reflected on the cover page hereof. This amendment only changes the cover page, Item 15, the exhibit index, adds Exhibits 23.1 and 23.2 and, as a result of this filing, includes additional Exhibits 31.1.1, 31.2.1, 32.1.1 and 32.2.1.

Table of Contents

PART IV

Item 15. Exhibits and Financial Statement Schedules.

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

1. Financial Statements

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

3. Exhibits

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

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Power Integrations, Inc.

We have audited the accompanying consolidated balance sheets of Power Integrations, Inc. and its subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders equity, and cash flows for the years then ended. Our audits also included the consolidated financial statement schedule for the years ended December 31, 2006 and 2005 listed in the Index at Item 15 (a)(2). These consolidated financial statements and consolidated financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the consolidated financial statements and consolidated financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, on January 1, 2006, the Company changed its method of accounting for stock-based compensation in accordance with guidance provided in Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment.*

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 7, 2007 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an adverse opinion on the effectiveness of the Company s internal control over financial reporting because of material weaknesses.

/s/ DELOITTE & TOUCHE LLP

San Jose, California

August 7, 2007

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Power Integrations, Inc.:

We have audited the accompanying consolidated statements of income, stockholders equity and cash flows of Power Integrations, Inc. and subsidiaries (the Company) for the year ended December 31, 2004. In connection with our audit of the consolidated financial statements, we have also audited the financial statement schedule for the year ended December 31, 2004 as listed in the index of Item 15. These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Power Integrations, Inc. and subsidiaries for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Mountain View, California

March 15, 2005, except as to note 14,

which is as of March 8, 2007.

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and par value amounts)

	December 31, 2006	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 124,937	$ 109,879
Restricted cash	1,300	
Short-term investments	2,506	16,200
Accounts receivable, net of allowances of $527 and $469 in 2006 and 2005, respectively	10,489	13,488
Inventories	28,280	17,929
Deferred tax assets	2,199	1,551
Prepaid expenses and other current assets	4,009	1,328
Total current assets	173,720	160,375
INVESTMENTS	3,999	4,422
NOTE RECEIVABLE	10,000	10,000
PROPERTY AND EQUIPMENT, net	53,475	48,890
INTANGIBLE ASSETS, net	5,895	3,594
DEFERRED TAX ASSETS	13,485	9,221
OTHER ASSETS	285	419
Total assets	$ 260,859	$ 236,921
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 8,592	$ 5,410
Accrued payroll and related expenses	8,668	7,038
Taxes payable	14,509	10,277
Deferred income on sales to distributors	4,901	3,479
Accrued professional fees	3,294	1,270
Other accrued liabilities	129	88
Total current liabilities	40,093	27,562
COMMITMENTS AND CONTINGENCIES (Notes 3 and 7)		
STOCKHOLDERS EQUITY:		
Preferred Stock, $0.001 par value		
Authorized 3,000,000 shares		
Outstanding None		
Common Stock, $0.001 par value		
Authorized 140,000,000 shares		
Outstanding 28,657,897 and 29,366,720 in 2006 and 2005, respectively	29	29
Additional paid-in capital	135,307	134,196
Deferred compensation		(746)
Accumulated translation adjustment	4	(121)
Retained earnings	85,426	76,001

Total stockholders equity	220,766	209,359
Total liabilities and stockholders equity	$ 260,859	$ 236,921

See accompanying notes to consolidated financial statements.

6

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

	Year Ended December 31, 2006	2005	2004
NET REVENUES	$ 162,403	$ 143,071	$ 136,653
COST OF REVENUES	73,794	72,979	71,856
GROSS PROFIT	88,609	70,092	64,797
OPERATING EXPENSES:			
Research and development	24,415	17,111	15,440
Sales and marketing	25,712	18,314	16,070
General and administrative	34,648	15,665	7,969
Total operating expenses	84,775	51,090	39,479
INCOME FROM OPERATIONS	3,834	19,002	25,318
OTHER INCOME (EXPENSE):			
Interest income	6,468	3,820	1,809
Interest expense	(6)	(218)	265
Other, net	(538)	(453)	(754)
Total other income	5,924	3,149	1,320
INCOME BEFORE PROVISION FOR INCOME TAXES	9,758	22,151	26,638
PROVISION FOR INCOME TAXES	333	6,453	6,138
NET INCOME	$ 9,425	$ 15,698	$ 20,500
EARNINGS PER SHARE:			
Basic	$ 0.32	$ 0.53	$ 0.67
Diluted	$ 0.31	$ 0.51	$ 0.64
SHARES USED IN PER SHARE CALCULATION:			
Basic	29,059	29,568	30,802
Diluted	30,819	30,843	32,229

See accompanying notes to consolidated financial statements.

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Common Stock		Additional Paid-In	Deferred	Accumulated Translation	Retained	Total Stockholders
	Shares	Amount	Capital	Compensation	Adjustment	Earnings	Equity
BALANCE AT JANUARY 1, 2004	30,408	$ 30	$ 161,843	$ (7,001)	$ (121)	$ 39,803	$ 194,554
Issuance of common stock under employee stock option plan	492		6,805				6,805
Repurchase of common stock	(590)		(11,799)				(11,799)
Issuance of common stock under employee stock purchase plan	182		2,294				2,294
Excess income tax benefits from employee stock option exercises			2,108				2,108
Stock-based compensation expense for variable awards			(2,558)	491			(2,067)
Stock-based compensation expense for fixed awards			(80)	117			37
Amortization of deferred stock-based compensation				3,317			3,317
Translation adjustment					7		7
Net income						20,500	20,500
BALANCE AT DECEMBER 31, 2004	30,492	30	158,613	(3,076)	(114)	60,303	215,756
Issuance of common stock under employee stock option plan	414		5,467				5,467
Repurchase of common stock	(1,692)	(1)	(33,661)				(33,662)
Issuance of common stock under employee stock purchase plan	153		2,407				2,407
Excess income tax benefits from employee stock option exercises			646				646
Stock-based compensation expense for variable awards			744	16			760
Stock-based compensation expense for fixed awards			(20)	27			7
Amortization of deferred stock-based compensation				2,287			2,287
Translation adjustment					(7)		(7)
Net income						15,698	15,698
BALANCE AT DECEMBER 31, 2005	29,367	29	134,196	(746)	(121)	76,001	209,359
Issuance of common stock under employee stock option plan	294		4,248				4,248
Repurchase of common stock	(1,085)		(19,643)				(19,643)
Issuance of common stock under employee stock purchase plan	82		1,315				1,315
Excess income tax benefits from employee stock option exercises			179				179
Stock-based compensation expense related to employee stock options			15,114				15,114
Stock-based compensation expense related to employee stock purchases			644				644
.							
Elimination of deferred compensation in relation to the adoption of SFAS No. 123(R)			(746)	746			

Translation adjustment					125		125
Net income						9,425	9,425
BALANCE AT DECEMBER 31, 2006	28,658	$ 29	$ 135,307	$	$ 4	$ 85,426	$ 220,766

See accompanying notes to consolidated financial statements.

8

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31,		
	2006	**2005**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 9,425	$ 15,698	$ 20,500
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	7,097	6,264	6,880
Stock-based compensation expense	15,460	3,118	1,288
Deferred income taxes	(4,912)	(24)	737
Provision for accounts receivable and other allowances	420	593	445
Excess tax benefit from stock options exercised	(172)		
Tax benefit associated with employee stock plans	179	646	2,108
Stock compensation to non-employees		7	37
Change in operating assets and liabilities:			
Accounts receivable	2,579	(1,331)	(2,360)
Inventories	(10,053)	7,473	(2,241)
Prepaid expenses and other assets	(2,545)	1,121	295
Accounts payable	2,295	(3,170)	396
Taxes payable and other accrued liabilities	8,035	5,208	1,501
Deferred income on sales to distributors	1,422	421	493
Net cash provided by operating activities	29,230	36,024	30,079
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(10,082)	(3,190)	(6,363)
Acquisition of technology patents/licenses	(3,000)	(1,101)	(1,740)
Loan to supplier		(10,000)	
Restricted cash	(1,300)		
Purchases of available-for-sale investments			(45,775)
Proceeds from sales of available-for-sale investments		11,200	52,890
Purchases of held-to-maturity investments	(24,851)	(7,806)	(30,183)
Proceeds from sales of held-to-maturity investments	38,969	3,144	19,182
Net cash used in investing activities	(264)	(7,753)	(11,989)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from issuance of common stock	5,563	7,874	9,101
Repurchase of common stock	(19,643)	(33,662)	(11,799)
Excess tax benefit from stock options exercised	172		
Principal payments under capitalized lease obligations			(41)
Net cash used by financing activities	(13,908)	(25,788)	(2,739)
NET INCREASE IN CASH AND CASH EQUIVALENTS	15,058	2,483	15,351
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	109,879	107,396	92,045
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 124,937	$ 109,879	$ 107,396

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:						
Unpaid property and equipment	$	887	$	(165)	$	32
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:						
Cash paid for interest	$	6	$		$	
Cash paid for income taxes, net	$	909	$	1,385	$	(157)

See accompanying notes to consolidated financial statements.

9

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006

1. THE COMPANY:

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

The Company is subject to a number of risks including, among others, the volume and timing of orders received from customers, competitive pressures on selling prices, the demand for its products declining in the major end markets it serves, SEC and U.S Department of Justice investigations and stockholder litigation related to the Company s recent internal investigation (see note 7), recently enacted changes in securities laws and regulations, including the Sarbanes-Oxley Act of 2002, the inability to adequately protect or enforce its intellectual property rights, expenses it is required to incur in connection with its litigation against Fairchild Semiconductor and System General Corporation, the volume and timing of orders placed by it with its wafer foundries and assembly subcontractors, fluctuations in the exchange rate between the U.S. dollar and the Japanese yen, the licensing of its intellectual property to one of its wafer foundries, the lengthy timing of its sales cycle, undetected defects and failures in meeting the exact specifications required by its products, reliance on its international sales activities which account for a substantial portion of net revenues, its ability to develop and bring to market new products and technologies on a timely basis, the ability of its products to penetrate additional markets, attraction and retention of qualified personnel in a competitive market, changes in environmental laws and regulations, the adoption of anti-takeover measures, the volatility of the future trading price of its common stock and earthquakes, terrorist acts or other disasters.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation

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

Estimates

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

Foreign Currency Translation

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash and Cash Equivalents and Investments

The Company considers cash invested in highly liquid financial instruments with a remaining maturity of three months or less at date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of December 31, 2006 and 2005, the Company s short-term and long-term investments consisted of U.S. government backed securities, municipal bonds, corporate commercial paper and other high quality commercial securities, which were valued using the amortized cost method, which approximates fair market value. All investments are classified as held-to-maturity except auction rate securities which are classified as available-for-sale. At the end of fiscal 2005 and fiscal 2006, the Company held no auction rate securities.

The table below summarizes the carrying value of the Company s investments by major security type (in thousands):

	December 31, 2006	December 31, 2005
Cash Equivalents:		
Taxable securities	$ 110,922	$ 86,037
Tax-exempt securities		6
Total cash equivalents	110,922	86,043
Short-term Investments:		
U.S. corporate securities	6	1,670
U.S. government securities	2,500	14,530
Total short-term investments	2,506	16,200
Investments, matures in excess of 1 year	3,999	4,422
Total investment securities	$ 117,427	$ 106,665

Restricted Cash

The Company s restricted cash balance of $1.3 million at December 31, 2006 consists of an interest-bearing certificate of deposit at Union Bank of California. The certificate of deposit bears interest at rates ranging from 3.55% to 4.64% and is renewed every 90 days. The current maturity for the certificate of deposit is July 30, 2007. The Company entered into a security agreement with the bank, whereby it agreed to maintain $1.3 million in an interest-bearing certificate of deposit with the bank. The certificate of deposit is restricted based on the bank s requirement that the Company maintain a restricted cash account in order to secure commercial letters of credit or standby letters of credit up to the deposit amount. This account is established in accordance with an agreement between the Company and the bank. As of December 31, 2006, there were two outstanding letters of credit totaling approximately $1.2 million. This agreement remains in effect until cancellation of the Company s letters of credit or until the Company reestablishes its line of credit with the Union Bank of California.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inventories

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

	December 31, 2006	December 31, 2005
Raw materials	$ 7,869	$ 1,683
Work-in-process	6,767	6,431
Finished goods	13,644	9,815
Total	$ 28,280	$ 17,929

Property and Equipment

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

	December 31, 2006	December 31, 2005
Land	$ 16,453	$ 16,453
Building and improvements	25,200	25,049
Machinery and equipment	49,600	41,130
Office furniture and equipment	15,436	13,249
	106,689	95,881
Accumulated depreciation	(53,214)	(46,991)
Total	$ 53,475	$ 48,890

Depreciation and amortization expense of property and equipment for fiscal years ending 2006 and 2005 was approximately $6,398 and $5,853, respectively, and was determined using the straight-line method over the following useful lives:

Building and improvements	4-40 years or life of lease agreement, if shorter
Machinery and equipment	2-5 years
Office furniture and equipment	4 years

Total fixed assets located in the United States at December 31, 2006, 2005 and 2004 were approximately 81%, 85% and 87%, of total long-lived assets, respectively. Of the total long-lived assets located in foreign countries, there was no individual country that held a material amount.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Intangible Assets

Intangible assets consist primarily of acquired licenses and patent rights and are reported net of accumulated amortization. We amortize the cost of intangible assets over the term of the acquired license or patent rights, which range from five to twelve years. In fiscal 2006, we acquired a technology license for $3.0 million, which has a ten year useful life. Amortization for intangible assets was approximately $0.7 million in 2006, and $0.4 million in 2005. We do not believe there is any significant residual value associated with the following intangible assets:

	December 31, 2006			December 31, 2005		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
			(In thousands)			
Patent rights	$ 3,165	$ (978)	$ 2,187	$ 3,165	$ (617)	$ 2,548
Technology licenses	4,057	(375)	3,682	1,057	(44)	1,013
Other intangibles	37	(11)	26	37	(4)	33
Total Intangible Assets	$ 7,259	$ (1,364)	$ 5,895	$ 4,259	$ (665)	$ 3,594

The estimated future amortization expense related to intangible assets at December 31, 2006 is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2007	$ 774
2008	774
2009	763
2010	728
2011	696
Thereafter	2,160
Total	$ 5,895

Impairment of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets, such as property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimate undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and would no longer be depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet. Currently the Company has no impairment of long-lived assets nor any assets held for disposal.

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

weighted-average shares of common stock and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares included in the diluted calculation consist of dilutive shares issuable upon the exercise of outstanding common stock options and computed using the treasury stock method.

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

	Year Ended December 31,		
	2006	2005	2004
Basic earnings per share:			
Net income	$ 9,425	$ 15,698	$ 20,500
Weighted-average common shares	29,059	29,568	30,802
Basic earnings per share	$ 0.32	$ 0.53	$ 0.67
Diluted earnings per share:			
Net income	$ 9,425	$ 15,698	$ 20,500
Weighted-average common shares	29,059	29,568	30,802
Effect of dilutive securities:			
Stock options	1,760	1,264	1,386
Employee stock purchase plan		11	41
Diluted weighted-average common shares	30,819	30,843	32,229
Diluted earnings per share	$ 0.31	$ 0.51	$ 0.64

Options to purchase 3,554,345, 1,969,496 and 1,639,142 shares of Company s common stock outstanding for the years ended December 31, 2006, 2005 and 2004, respectively, were not included in the computation of diluted earnings per share. This was due to the exercise prices of these options to purchase shares of the Company s common stock being greater than the average market price of the Company s common stock during those periods, making their effect anti-dilutive.

Comprehensive Income

Comprehensive income for the Company consists of net income plus the effect of foreign currency translation adjustments and unrealized gains / losses on available for sale securities, net of income taxes, which is not material for each of the three years ended December 31, 2006, 2005 and 2004. Accordingly, comprehensive income closely approximates actual net income.

Segment Reporting

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

Revenue Recognition, Significant Customers

Product revenues consist of sales to OEMs, merchant power supply manufacturers and distributors. Shipping terms to international OEMs and merchant power supply manufacturers from the Company s facility in

14

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

California are delivered at frontier, commonly referred to as DAF. As such, title to the product passes to the customer when the shipment reaches the destination country, and revenue is recognized upon the arrival of the Company s product in that country. Beginning in December 2005, shipping terms to the Company s international OEMs and merchant power supply manufacturers shipped from the Company s facility outside of the United States are EX Works (EXW), meaning that title to the product transfers to the customer upon shipment from the Company s foreign warehouse. Shipments to North and South American OEMs and merchant power supply manufacturers are FOB-point of origin meaning revenue is recognized upon shipment, when the title is passed to the customer.

Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company s products held by the distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell the Company s products to their customers. The Company determines the amounts to defer based on the level of actual inventory on hand at its distributors as well as inventory that is in transit to its distributors. The gross profit that is deferred as a result of this policy is reflected as deferred income on sales to distributors in the accompanying consolidated balance sheets.

Net revenue is reduced by estimated sales returns and allowances. The Company analyzes the following factors: historical returns, current economic trends, levels of inventories of the Company s products held by its customers, and changes in customer demand and acceptance of the Company s products and uses this information to review and determine the adequacy of the reserve. This reserve represents a reserve of the gross margin on estimated future returns and is reflected as a reduction to accounts receivable in the accompanying consolidated balance sheets. Increases to the reserve are recorded as a reduction to net revenue equal to the expected customer credit memo and a corresponding credit is made to cost of revenues equal to the estimated cost of the returned product. The net difference, or gross margin, is recorded as an addition to the reserve.

Approximately 63% of the Company s sales were made to distributors in 2006. Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. After the distributor ships product to its customer, the distributor submits a ship and debit claim to the Company to adjust its cost from the standard price to the pre-approved lower price. After verification by the Company, a credit memo is issued to the distributor to adjust the sell-in price from the standard distribution price to the approved lower price. The Company maintains a reserve for these credits that appears as a reduction to accounts receivable in the Company s accompanying consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in the Company s net revenues. To establish the adequacy of its reserves, the Company analyzes historical ship and debit payments and levels of inventory in the distributor channels.

From time to time the Company will reduce the distribution list price. As a result, the Company gives distributors protection, in the form of credits, against price declines on products they hold. The credits are referred to as price protection. Since the Company does not recognize revenue until the distributor sells the product to its customers, the Company generally does not need to provide reserves for price protection. However, in rare instances the Company must consider price protection in the analysis of reserve requirements, as there may be a timing gap between a price decline and the issuance of price protection credits. If a price protection reserve is required, the Company will maintain a reserve for these credits that appears as a reduction to accounts receivable in the Company s accompanying consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in the Company s net revenues. The Company analyzes distribution price declines and levels of inventory in the distributor channels in determining the reserve levels required.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the years ended December 31, 2006, 2005 and 2004, the Company s top ten customers, including distributors that resell the Company s products to OEMs and merchant power supply manufacturers, accounted for approximately 58%, 69% and 71% of net revenues, respectively.

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

	Year Ended December 31,		
Customer	**2006**	**2005**	**2004**
Avnet (formerly Memec)	23%	19%	19%
Synnex Technologies		18%	19%

Export Sales

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

	Year Ended December 31,		
	2006	**2005**	**2004**
Taiwan	15%	27%	25%
Hong Kong/China	32%	24%	26%
Korea	20%	20%	19%
Western Europe	10%	10%	9%
Germany	5%	4%	5%
Japan	5%	5%	4%
Singapore	3%	3%	2%
Other	3%	%	2%
Total export sales	93%	93%	92%

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

Product Sales

Sales of TOPSwitch and TinySwitch products accounted for 89%, 95% and 97% of total net revenues in 2006, 2005 and 2004, respectively. TOPSwitch products include TOPSwitch, TOPSwitch-II, TOPSwitch-FX, and TOPSwitch-GX. TinySwitch products include TinySwitch, TinySwitch II, TinySwitch-III and PeakSwitch.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue mix by product family is comprised of the following:

	Year Ended December 31,		
Product Family	**2006**	**2005**	**2004**
TinySwitch	53%	57%	54%
TOPSwitch	36%	38%	43%
LinkSwitch	9%	5%	3%
DPA-Switch	2%		

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

	Year Ended December 31,		
End Market	**2006**	**2005**	**2004**
Consumer	32%	30%	33%
Communications	28%	29%	31%
Computer	19%	23%	22%
Industrial	15%	11%	8%
Other	6%	7%	6%

Foreign Currency Risk

The Company does not currently employ a foreign currency hedge program utilizing foreign currency forward exchange contracts. The Company maintains a Japanese yen bank account with a U.S. bank for payments to suppliers and for cash receipts from Japanese suppliers and customers denominated in yen. For the years ended December 31, 2006, 2005 and 2004, the Company realized foreign exchange transaction losses of approximately $236,000, $167,000 and $336,000, respectively. These amounts are included in other income (expense) in the accompanying consolidated statements of income.

Warranty

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

Advertising

Advertising costs are expensed as incurred. Advertising costs amounted to $0.8 million, $0.8 million, and $0.6 million, in 2006, 2005 and 2004, respectively.

Research and Development

Research and development costs are expensed as incurred.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Stock-Based Compensation

Prior to January 1, 2006, the Company accounted for its share-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*. In accordance with SFAS No. 123, the Company disclosed its net income (loss) per share as if the Company had applied the fair value-based method in measuring compensation expense for its share-based incentive awards.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation expense that the Company recognizes beginning on that date includes expenses associated with the fair value of all awards granted on and after January 1, 2006, and expense for the unvested portion of previously granted awards outstanding on January 1, 2006. Results for prior periods have not been restated.

Determining Fair Value

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

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

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

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

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

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

Fair Value of Financial Instruments

The estimated fair value of the Company s note to its supplier was approximately $9.9 million at December 31, 2006. The fair value was estimated using a pricing model incorporating current market rates. The note had a carrying cost of $10.0 million at December 31, 2006.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The carrying value of cash, cash equivalents, restricted cash, investments, excluding the Company s note to its supplier, accounts receivable, accounts payable and accrued liabilities approximate their fair values as of December 31, 2006 and 2005, because of the relatively short maturity of these instruments.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company has cash investment policies that limit cash investments to low risk investments. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers financial condition and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past losses and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. As of December 31, 2006 and 2005, approximately 67% and 69% of accounts receivable, respectively, were concentrated with ten customers. The Company had two distribution customers that represented 22% and 8% of accounts receivable as of December 31, 2006. The Company s two largest distribution customers represented 18% and 11% of accounts receivable as of December 31, 2005.

Indemnifications

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

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of December 31, 2006. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS No. 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently in the process of

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

evaluating the impact that the adoption of SFAS No. 157 will have on its consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, (SFAS 158). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. The provisions of SFAS 158 require an employer with publicly traded equity securities to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The Company does not believe that the adoption of the provisions of SFAS No. 158 will materially impact its consolidated financial position and results of operation.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The guidance is applicable for the Company s fiscal year 2007. The Company does not believe that the adoption of SAB 108 will have a material impact on its consolidated financial position and results of operation.

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

In July 2006, FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 creates a single model to address accounting for uncertainty in tax positions by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the tax matter) that a tax position is more likely than not to be sustained on examination by a taxing authority. The second step, measurement, is only considered after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with the taxing authority or upon the expiration of the statute of

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

limitations. FIN 48 also significantly expands the financial statement disclosure requirements relating to uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company will adopt FIN 48 as of January 1, 2007. Differences between the amounts recognized in the balance sheet prior to adoption and the amounts recognized in the balance sheet after adoption will be accounted for as a cumulative effect adjustment to the beginning balance of retained earnings. The Company has substantially completed its analysis and documentation of any potential impacts of implementing FIN 48. The Company has concluded that its tax contingencies will decrease by approximately $1 million as a result of the implementation of FIN 48.

During fiscal 2006, the Company adopted the following accounting standards, and concluded that none of these standards had a material effect on its consolidated results of operations during such period or at the end of such period:

FASB interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143* (FIN 47), which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability s fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005.

SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), replacing Accounting Principles Board Opinions No. 20 *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28*. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. The Company adopted this pronouncement as of January 1, 2006 for error corrections made on or after the date of adoption.

FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The Company adopted FSP 115-1 in the first quarter of fiscal 2006.

EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (that is, Gross versus Net Presentation)* (EITF 06-3). EITF 06-3 provides guidance on the presentation in the income statement of any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer. EITF 06-3 requires that taxes be presented in the income statement either on a gross basis (included in revenues and costs) or a net basis (excluded from revenues). EITF 06-3 also requires certain disclosures on a retrospective basis, if the amounts are significant. The Company s accounting policy is to present the above-mentioned taxes on a net basis, and has concluded that EITF 06-3 does not have a material effect on its financial statements. EITF 06-3 was issued by FASB in July 2006, and adopted by the Company during fiscal 2006.

3. COMMITMENTS AND CONTINGENCIES:

Customer Claims 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. During 2004, a small number of product lots of one of the Company s products were not built to design specifications because of a foundry

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

process defect. As a result of this manufacturing defect, there were a limited number of product failures and the Company replaced all of the parts that had not yet been installed in end-customer products. Several customers made requests for reimbursement of costs and expenses in excess of the Company s contractual warranty liability. In accordance with SFAS No. 5, *Accounting for Contingencies*, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. After further discussions with its customers, the Company determined that it was appropriate to accrue approximately $481,000 during 2005, related to this manufacturing defect, for customer costs and expenses in excess of the Company s contractual warranty liability. The Company did not incur additional charges related to this matter and all customer claims were settled in 2006.

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

The Company had no capital leasing arrangements as of December 31, 2006. At December 31, 2006 the Company had $15.1 million of non-cancelable purchase obligations.

Future minimum lease payments under all non-cancelable operating lease agreements as of December 31, 2006 are as follows (in thousands):

Fiscal Year	
2007	$ 548
2008	308
2009	162
2010	68
2011	21
Total minimum lease payments	$ 1,107

Total rent expense amounted to $0.5 million, $0.4 million and $0.4 million in the years ended December 31, 2006, 2005 and 2004, respectively.

Bank Line of Credit The Company had a $10.0 million revolving line of credit agreement with Union Bank of California, which expired on October 1, 2006, and restricted the Company from entering into certain transactions, paying or declaring dividends without the bank s prior consent and contained certain financial covenants. As of December 31, 2006 and 2005, there were no amounts due under the bank line of credit. A portion of the credit line was used to cover advances for commercial letters of credit and standby letters of credit, used primarily for the shipment of wafers from wafer supply manufactures to the Company, and also to its workers compensation insurance carrier as part of its insurance program. As of December 31, 2005, there were outstanding letters of credit totaling approximately $641,000, and as of December 31, 2006 there were outstanding letters of credit totaling approximately $1.2 million. On October 26, 2006, the Company entered into a security agreement with Union Bank of California, whereby it agreed to maintain $1.3 million in an interest bearing certificate of deposit with the bank. The purpose of this agreement is to secure the commercial letters of credit and standby letters of credit. This agreement remains in effect until cancellation of the Company s letters of credit.

4. PREFERRED STOCK PURCHASE RIGHTS PLAN:

In February 1999, the Company adopted a Preferred Stock Purchase Rights Plan (the Plan) designed to enable all stockholders to realize the full value of their investment and to provide for fair and equal treatment for

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

all stockholders in the event that an unsolicited attempt is made to acquire the Company. Under the Plan, stockholders received one right to purchase one one-thousandth of a share of a new series of preferred stock for each outstanding share of common stock held at $150.00 per right, when someone acquires 15 percent or more of the Company s common stock or announces a tender offer which could result in such person owning 15 percent or more of the common stock. Each one one-thousandth of a share of the new preferred stock has terms designed to make it substantially the economic equivalent of one share of common stock. Prior to someone acquiring 15 percent, the rights can be redeemed for $0.001 each by action of the board of directors. Under certain circumstances, if someone acquires 15 percent or more of the common stock, the rights permit the stockholders, other than the acquirer, to purchase the Company s common stock having a market value of twice the exercise price of the rights, in lieu of the preferred stock. Alternatively, when the rights become exercisable, the board of directors may authorize the issuance of one share of common stock in exchange for each right that is then exercisable. The Company s Board of Directors may, in its discretion, permit a stockholder to increase its ownership percentage to an amount in excess of 15 percent without triggering the provisions of the Plan, and has done so with respect to one investor, allowing that investor to acquire up to 20 percent of the Company s common stock without triggering the provisions of the Plan. In addition, in the event of certain business combinations, the rights permit the purchase of the common stock of an acquirer at a 50 percent discount. Rights held by the acquirer will become null and void in both cases. The rights expire on February 23, 2009.

5. STOCKHOLDERS EQUITY:

Preferred Stock

The Company is authorized to issue 3,000,000 shares of $0.001 par value preferred stock, none of which was issued or outstanding during each of the three years ended December 31, 2006, 2005 and 2004.

Common Stock

As of December 31, 2006, the Company was authorized to issue 140,000,000 shares of $0.001 par value common stock.

On October 20, 2004, the Company announced that its board of directors had authorized the repurchase of up to $40 million of the Company s common stock. The board directed that the repurchases be made pursuant to Rule 10b5-1 of the Exchange Act. From inception of the stock repurchase program in October 2004 through June 30, 2005, the Company repurchased 2,033,270 shares for approximately $40 million. On October 19, 2005, the Company announced that its board of directors had authorized a second stock repurchase program of up to $25 million of the Company s common stock, with the repurchases again to be made pursuant to Rule 10b5-1 of the Exchange Act. From inception of this second repurchase plan through June 2006, the Company purchased a total of 1,334,216 shares for a total of approximately $25 million, concluding this repurchase program.

1988 Stock Option Plan

In June 1988, the board of directors adopted the 1988 Stock Option Plan (the 1988 Plan), whereby the board of directors may grant incentive stock options and non-qualified stock options to key employees, directors and consultants to purchase the Company s common stock. The exercise price of incentive stock options may not be less than 100% of the fair market value of the Company s common stock on the date of grant. The exercise price of non-qualified stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. In general, options vest over either 48 or 50 months. Options generally have a maximum term of ten years after the date of grant (five years if an incentive stock option is granted to a ten percent owner optionee), subject to earlier termination upon an optionee s cessation of employment or service.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effective July 1997, the board of directors determined that no further options would be granted under the 1988 Plan, but all outstanding options would continue to be governed and remain outstanding in accordance with their existing terms.

1997 Stock Option Plan

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the 1997 Plan), whereby the board of directors may grant incentive stock options and non-qualified stock options to key employees, directors and consultants to purchase the Company s common stock. The exercise price of incentive stock options may not be less than 100% of the fair market value of the Company s common stock on the date of grant. The exercise price of non-qualified stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. The 1997 Plan originally provided that the number of shares reserved for issuance automatically increased on each January 1st, from January 1, 1999 through January 1, 2007, by 5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. In January 2005, the board of directors amended the 1997 Plan to reduce the annual increase from 5% to 3.5%, so that the number of shares reserved for issuance automatically increase on each January 1st, from January 1, 2006 through January 1, 2007, by 3.5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. As of December 31, 2006, the maximum number of shares that may be issued under the 1997 Plan was 14,085,792 shares, which was comprised of (i) 11,142,828 shares (new shares allocated to the 1997 Plan) and (ii) 2,942,964 shares granted pursuant to the 1988 Plan (the 1988 Plan Options). In general, options vest over 48 months. Options generally expire no later than ten years after the date of grant (five years if an incentive stock option is granted to a ten percent owner optionee), subject to earlier termination upon an optionee s cessation of employment or service.

1997 Outside Directors Stock Option Plan

In September 1997, the board of directors adopted the 1997 Outside Directors Stock Option Plan (the Directors Plan). A total of 800,000 shares of common stock have been reserved for issuance under the Directors Plan. The Directors Plan is designed to work automatically without administration; however, to the extent administration is necessary, it will be performed by the board of directors. The Directors Plan provides for the automatic grant of nonstatutory stock options to nonemployee directors of the Company over their period of service on the board of directors. The Directors Plan provides that each future nonemployee director of the Company will be granted an option to purchase 30,000 shares of common stock on the date on which such individual first becomes a nonemployee director of the Company (the Initial Grant). Thereafter, each nonemployee director who has served on the board of directors continuously for 12 months will be granted an additional option to purchase 10,000 shares of common stock (an Annual Grant). Subject to an optionee s continuous service with the Company, approximately 1/3rd of an Initial Grant will become exercisable one year after the date of grant and 1/36th of the Initial Grant will become exercisable monthly thereafter. Each Annual Grant will become exercisable in twelve equal monthly installments beginning in the 25th month after the date of grant, subject to the optionee s continuous service. The exercise price per share of all options granted under the Directors Plan is equal to the fair market value of a share of common stock on the date of grant. Options granted under the Directors Plan have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee s cessation of service. In the event of certain changes in control of the Company, all options outstanding under the Directors Plan will become immediately vested and exercisable in full.

1998 Nonstatutory Stock Option Plan

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the 1998 Plan), whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the extent that such options do not require approval of the Company s stockholders. The 1998 Plan has not been approved by the Company s stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. As of December 31, 2006, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000 shares. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee s cessation of employment or service.

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

	Year Ended December 31,						
	2006		Aggregate Intrinsic Value	2005		2004	
	Shares	Price		Shares	Price	Shares	Price
Options outstanding, Beginning of year	7,569,854	$ 19.09		6,689,279	$ 18.99	5,752,100	$ 16.62
Granted:							
Below fair market value				138,668	$ 21.08	242,000	$ 21.64
At fair market value	1,420,992	$ 24.80		1,409,181	$ 18.14	1,467,037	$ 26.27
Total granted	1,420,992	$ 24.80		1,547,849	$ 18.40	1,709,037	$ 25.62
Exercised	(293,501)	$ 14.45		(414,070)	$ 13.29	(491,812)	$ 13.76
Cancelled	(205,815)	$ 22.79		(253,204)	$ 21.79	(280,046)	$ 19.98
Options outstanding, end of year	8,491,530	$ 20.18		7,569,854	$ 19.09	6,689,279	$ 18.99
Vested and exercisable, end of year	5,980,620	$ 19.17		4,950,914	$ 17.97	3,870,840	$ 17.14
Vested and expected to vest at 12/31/06	8,170,325	$ 20.09	$ 40,501,214				
Weighted-average fair value per option granted below fair market value		$			$ 15.77		$ 17.41
Weighted-average fair value per option granted at fair market value		$ 13.20			$ 12.91		$ 19.60

The weighted-average grant-date fair value of options granted for the twelve months ended December 31, 2006 was $13.20. The total intrinsic value of options exercised during the twelve months ending December 31, 2006 was $3.4 million.

Options issued under the 1988, 1997 and 1998 plans may be exercised at any time prior to their expiration. The Company has a repurchase right that lapses over time, under which it has the right, upon termination of an optionholder s employment or service with the Company, at its discretion, to repurchase any unvested shares issued under the 1988, 1997 and 1998 plans at the original purchase price. Under the terms of the option plans, an

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

option holder may not sell shares obtained upon the exercise of an option until the option has vested as to those shares. As of December 31, 2006, 2005 and 2004, there were no shares of common stock issued under the 1988, 1997 and 1998 plans that are subject to repurchase by the Company. Options issued under the Directors Plan are exercisable upon vesting.

The following table summarizes the stock options outstanding at December 31, 2006:

		Options Outstanding			Options Vested and Exercisable	
Exercise Price		Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Vested	Weighted Average Exercise Price
$ 0.68	$ 4.38	127,072	1.11	$ 3.49	127,072	$ 3.49
$ 4.42	$12.10	910,427	4.35	$ 11.95	910,427	$ 11.95
$12.12	$14.82	970,317	4.80	$ 14.60	960,717	$ 14.61
$14.90	$16.70	560,659	5.11	$ 15.46	400,659	$ 15.22
$17.00	$20.51	2,629,542	7.07	$ 18.04	1,772,246	$ 18.10
$20.55	$24.64	657,983	6.99	$ 22.61	382,015	$ 22.84
$24.79	$28.55	2,195,464	8.04	$ 26.92	1,023,679	$ 27.11
$28.81	$29.50	45,839	5.24	$ 29.27	38,540	$ 29.26
$31.50	$36.56	311,641	4.83	$ 34.98	282,679	$ 35.15
$36.88	$43.88	65,311	3.04	$ 42.81	65,311	$ 42.81
$44.75	$51.50	17,275	3.13	$ 45.61	17,275	$ 45.61
$ 0.68	$51.50	8,491,530	6.41	$ 20.18	5,980,620	$ 19.17

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee s compensation, to the purchase of shares of the Company s common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company s common stock on the first day of each two-year offering period, or (ii) the fair market value of the Company s common stock on the semi-annual purchase date. If the fair market value of the Company's common stock on any semi-annual purchase date within a two-year offering period is less than the fair market value per share on the first day of such offering period, then immediately following purchase of shares of the Company's common stock on that semi-annual purchase date, participants will be automatically withdrawn from the offering period and enrolled in a new two-year offering period beginning immediately thereafter. An aggregate of 2,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of December 31, 2006, 1,609,300 shares had been purchased and 390,700 shares were reserved for future issuance. In April 2006, the Company temporarily suspended the Purchase Plan due to the Company s delisted status with The NASDAQ.

Non-employee Stock Options

In 2006 and 2005, the Company granted no non-employee options. In 2004, the Company granted to non-employees options to acquire 1,000 shares of common stock under the 1997 Plan, at a weighted-average exercise price of $27.22 per share. As of December 31, 2006 there were no non-employee options outstanding.

Shares Reserved

As of December 31, 2006, the Company had 2,974,063 shares of common stock reserved for future issuance under stock option and stock purchase plans.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Impact of the Adoption of SFAS No. 123(R)

Prior to January 1, 2006, the Company accounted for its share-based employee compensation plans under the measurement and recognition provisions of APB 25. The following table presents the functional allocation of all share-based compensation and related expense included in the Company s operating expense captions that the Company recorded for the fiscal years 2005 and 2004 (in thousands):

	Year ended December 31,	
	2005	2004
Cost of sales	$ 405	$ 512
Research and development	994	(130)
Sales and marketing	655	969
General and administrative	1,064	(63)
Total	$ 3,118	$ 1,288

See Note 2, Summary of Significant Accounting Policies, in the notes to consolidated financial statements for a description of the Company s adoption of SFAS No. 123(R) on January 1, 2006. The following table presents the functional allocation of all share-based compensation and related expense included in the Company s operating expense captions that the Company recorded within the accompanying consolidated statements of income for fiscal 2006 (in thousands):

	Year ended December 31, 2006
Cost of sales	$ 1,250
Research and development	4,329
Sales and marketing	5,506
General and administrative	4,375
Total	$ 15,460

The Company recorded $15.5 million in pre-tax share-based compensation expenses, including expenses related to grants of stock options and purchase rights under the employee stock purchase plan during the year ended December 31, 2006. These expenses consisted of approximately $15.2 million related to stock options and $0.6 million related to our employee stock purchase plan, reduced by approximately $0.3 million for capitalized compensation expense. As of December 31, 2006, there was $20.0 million of total unamortized compensation cost which includes estimated forfeitures related to non-vested share-based compensation arrangements granted under all equity compensation plans. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Company expects to recognize that cost over a weighted-average period of 1.96 years.

The Company received $5.6 million in cash from option exercises and issuances of stock under the employee stock purchase plan during the year ended December 31, 2006.

The Company estimates the fair value of options granted using the Black-Scholes-Merton option valuation model. The Company estimates the expected volatility of its common stock at the date of grant based on a combination of its historical volatility and the volatility of comparable companies, consistent with SFAS No. 123(R) and Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107). The Company estimates expected term consistent with the simplified method identified in SAB 107 for share-based awards granted during the fiscal year ended December 31, 2006. The dividend yield assumption is based on historical dividend payouts. The risk-free interest rate assumption is based on observed interest rates

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

appropriate for the expected term of its employee options. The Company uses historical data to estimate pre-vesting option forfeitures (at an estimated forfeiture rate of 8.4% for the year ended December 31, 2006) and record share-based compensation expense only for those awards that are expected to vest. For options granted, the Company amortizes the fair value on a straight-line basis over the requisite service period of the options that is generally four years.

The weighted-average fair value of options granted is estimated on the date of grant using the Black-Scholes-Merton option-pricing model with the following weighted-average assumptions used for share-based payment awards during the years ended December 31, 2006, 2005 and 2004:

	2006	**2005**	**2004**
Stock Options			
Expected volatility	49%-52%	59%-85%	77%-92%
Risk-free interest rate	4.46%-5.00%	2.98%-4.49%	1.20%-4.39%
Expected life (in years)	6.03	6.03	6.03
Expected dividend yield			

	2006	**2005**	**2004**
Employee Stock Purchase Plan			
Expected volatility	37%	47%	53%
Risk-free interest rate	4.44%	3.19%	2.14%
Expected life (in years)	1.0	1.0	1.0
Weighted-average estimated fair value of the purchase rights	$6.81	$8.94	$8.33
Expected dividend yield			

For the years ended December 31, 2005 and 2004, the Company accounted for forfeitures under SFAS No. 123 based on actual forfeitures.

Under SFAS No. 123, the fair value of stock options at the date of grant is recognized in earnings over the vesting period of the options. Had compensation expense been determined under a fair value method consistent with SFAS No. 123 and related interpretations, the Company s net income would have been decreased to the following pro forma amounts (in thousands, except per share information) for the years ended December 31, 2005 and 2004.

	Year Ended December 31,	
	2005	**2004**
Net income, as reported	$ 15,698	$ 20,500
Add stock-based employee compensation expense included in reported net income, net of tax	2,383	619
Deduct total stock-based employee compensation expense determined under fair-value-based method for all awards, net of tax	(18,487)	(20,119)
Pro forma net income (loss)	$ (406)	$ 999
Basic earnings per share:		
As reported	$ 0.53	$ 0.67
Pro forma	$ (0.01)	$ 0.03
Diluted earnings per share:		
As reported	$ 0.51	$ 0.64
Pro forma	$ (0.01)	$ 0.03

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Had the Company not adopted SFAS 123(R), the Company has concluded that income before income taxes for fiscal year 2006 would have increased by approximately $15.4 million, and net income would have increased by approximately $12.3 million. Basic net income per share for fiscal year 2006 would have increased by approximately $.42, and diluted net income per share for fiscal 2006 would have increased by approximately $.40. For fiscal 2006, cash provided by operating activities would have increased by $0.2 million, and cash provided by financial activities would have decreased by $0.2 million related to excess tax benefits from equity-based compensation plans.

6. TAXES:

Payroll taxes, interest and penalties In connection with the stock-based compensation adjustments, the Company determined that certain options previously classified as Incentive Stock Option, or ISO, grants were determined to have been granted with an exercise price below the fair market value of the Company s stock on the revised measurement date (see discussion under Critical Accounting Policies in Item 7). Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant, and therefore these grants might not qualify for ISO tax treatment. The Company refers to these stock options as the Affected ISOs. The potential disqualification of ISO status exposes the Company to additional payroll related withholding taxes on the exercise of these Affected ISOs granted to U.S. employees, and penalties and interest for failing to properly withhold taxes on exercise of those options. The payroll taxes, interest and penalties were recorded as expenses in the periods in which the underlying stock options were exercised. Then, in subsequent periods in which the liabilities were legally extinguished due to statutes of limitations, the payroll taxes, interest and penalties were reversed, and recognized as a reduction in the related functional expense category in the Company s consolidated statements of income.

Income Taxes

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

	Year Ended December 31,		
	2006	2005	2004
U.S. operations	$ (16,523)	$ 6,945	$ 12,010
Foreign operations	26,281	15,206	14,628
Total pretax income	$ 9,758	$ 22,151	$ 26,638

Undistributed earnings of the Company s foreign subsidiaries of approximately $44.9 million at December 31, 2006, are considered to be indefinitely reinvested and, accordingly, no provision for Federal income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to various foreign countries.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Year Ended December 31,		
	2006	2005	2004
Current provision:			
Federal	$ 4,070	$ 6,798	$ 4,674
State	493	199	244
Foreign	682	556	485
	5,245	7,553	5,403
Deferred provision (benefit):			
Federal	(3,866)	(942)	1,256
State	(1,009)	(158)	(521)
Foreign	(37)		
	(4,912)	(1,100)	735
Total	$ 333	$ 6,453	$ 6,138

The Company is entitled to a deduction for Federal and state tax purposes with respect to employees stock option activity. The net reduction in taxes otherwise payable in excess of any amount credited to income tax benefit has been credited to additional paid-in capital. For 2006, 2005 and 2004, the benefit arising from employee stock option activity that resulted in a credit to additional paid in capital was approximately $0.2 million, $0.6 million and $2.1 million, respectively. In determining this benefit, the Company used the long form method.

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

	Year Ended December 31,		
	2006	2005	2004
Provision computed at Federal statutory rate	35.0%	35.0%	35.0%
State tax provision, net of Federal benefit	(7.1)	1.2	3.0
Research and development credits	(16.6)	(3.6)	(1.9)
Deferred compensation	31.2	1.7	(1.0)
Foreign income taxed at different rate	(39.8)	(4.6)	(8.6)
Release of reserve for tax contingency			(4.2)
Other	0.7	(0.6)	0.6
Total	3.4%	29.1%	23.0%

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	December 31, 2006	December 31, 2005
Deferred Tax Assets		
Tax credit carry-forwards	$ 5,708	$ 3,353
Inventory reserves	563	838
Other reserves and accruals	1,435	388
Depreciation	837	792
Stock compensation	7,141	5,403
	15,684	10,774
Deferred Tax Liability		
Foreign Taxes		(2)
Net deferred tax asset	$ 15,684	$ 10,772

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income. The Company limits the deferred tax assets recognized related to certain highly-paid officers of the Company to amounts that it estimates will be deductible in future periods based upon the provisions of the Internal Revenue Code Section 162(m). Based upon the level of historical taxable income and projections for future taxable income over the periods in which the temporary differences are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

As of December 31, 2006, the Company had California research and development tax credit carry forwards of approximately $6.4 million. There is no expiration of research and development tax credit carry forwards for the State of California. As of December 31, 2006, the Company had Federal research and development tax credit carry forwards of approximately $1.3 million, which will expire in 2025, if unutilized.

7. LEGAL PROCEEDINGS:

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

On May 9, 2005, the Company filed a Complaint with the ITC under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337. The Company filed a supplement to the complaint on May 24, 2005. The

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company alleged infringement of certain of its patents pertaining to pulse width modulation (PWM) integrated circuit devices. The Commission instituted an investigation on June 8, 2005 in response to the Company s complaint. Systems General Corporation filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. The Company subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (ALJ) from January 18 to January 24, 2006. The ALJ s initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. On June 30, 2006 the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing Systems General PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing Systems General chip. The U.S. Customs Service is authorized to enforce the exclusion order which is now in full effect. On December 6, 2006 System General filed a notice of appeal of the ITC decision. Briefing has been completed, and the appeal will be heard by the U.S. Court of Appeals for the Federal Circuit in the coming months.

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four Power Integrations patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $33,981,781 in damages. Although the jury awarded damages, and the Company will request the damages to be enhanced in view of the jury s finding on willfulness, at this stage of the proceedings the Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company s consolidated financial statements as a result of the damages award. Fairchild has raised defenses contending that the asserted patents are invalid or unenforceable, and the court set a second trial on these issues to begin on September 17, 2007.

On April 11, 2006, Fairchild Semiconductor Corporation and Intersil Corporation filed a patent infringement lawsuit against the Company in the U.S. District Court for the Eastern District of Texas. The complaint asserts that the Company infringed on an old Intersil patent that Fairchild recently secured exclusive rights to assert against the Company but Fairchild and Intersil did not identify any specific products they believe infringe the patent. The Company believes that Fairchild and Intersil s lawsuits are flawed because both Fairchild and Intersil lack standing to sue the Company and it is also duplicative of a portion of the Company s suit against Fairchild in Delaware, and the Company therefore filed a motion addressing both issues. The Texas Court granted the Company s motion to transfer the case to Delaware on March 6, 2007, and the case has been transferred to Delaware and assigned to Judge Farnan, the presiding judge in the Fairchild case discussed above. The Delaware Court had a status conference on August 2, 2007, and it scheduled a trial for September 8, 2008, but there have been no further developments in the case. The Company continues to believe Fairchild s case should be dismissed for lack of standing, and the Court has scheduled a hearing on that issue for October 5, 2007. Regardless, the Company does not expect Fairchild s suit to have any impact on its lawsuit against Fairchild.

On June 14, 2007, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against BCD Semiconductor Manufacturing Limited, a Chinese company, and its

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

U.S. subsidiary. The complaint alleges that certain integrated circuits produced by BCD infringe certain of the Company s patents. The Company seeks, among other things, an order enjoining BCD from infringing its patents and an award for damages resulting from the alleged infringement. BCD has not yet answered the complaint.

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of the Company, against certain of the Company s current and former executives and members of its board of directors relating to the Company s historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of the Company. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in the United States District Court for the Northern District of California purportedly on behalf of the Company. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco's counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. On August 3, 2007, plaintiffs filed an amended consolidated complaint. The amended consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of the Company s shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The amended consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. Power Integrations response to the amended consolidated complaint is due on September 12, 2007.

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

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

8. CHANGE IN ESTIMATE TO DEFERRED INCOME ON SALES TO DISTRIBUTORS:

The Company made a change to its estimation of deferred income on sales to distributors in the first quarter of 2005. This change of estimate resulted in the recognition of $1.1 million in previously deferred revenue, the recognition of $0.6 million of previously deferred costs, and an increase in net income after tax of approximately $0.4 million, which represented diluted earnings per share of approximately $0.01 for the year ended December 31, 2005. The impact of this change in estimate was not material to any of the Company s prior period financial statements.

9. LOAN TO SUPPLIER:

On August 30, 2005, the Company entered into a loan agreement with one of its suppliers to fund the implementation of new technology. The principal amount of the loan was $10.0 million. The unpaid principal and interest is due on December 31, 2009. The loan is convertible into equity of the supplier upon certain conditions at the discretion of the Company. The interest rate will follow the one-year Treasury bill rate, and be reset at each anniversary of the closing date of the loan agreement. The loan principal is reflected in Loan Receivable in the accompanying consolidated balance sheet.

10. PREPAYMENT TO A SUPPLIER TO SECURE WAFER MATERIAL:

In August of 2006, the Company entered into a wafer supply agreement amendment with its foundry, ZFoundry, which amends its previous agreement dated May of 2003. The amended agreement includes a prepayment of $2.3 million to ZFoundry to enable them to secure raw materials from their supplier. The Company included the prepayment in prepaid expenses and other current assets in its December 31, 2006 consolidated balance sheet.

11. INTANGIBLE ASSETS:

As of December 31, 2006, the Company has acquired intangible assets, net of amortization, of approximately $5.9 million. This includes an acquisition of a technology license, to be utilized in the production of the Company s products, for $3.0 million from its foundry OKI in the first quarter of 2006. The Company included this investment in Intangible Assets in its December 31, 2006 consolidated balance sheet. Intangible assets are amortized over their useful life, ranging from five to twelve years.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. DISTRIBUTOR PRICING CREDIT RECOVERY:

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

13. SELECTED QUARTERLY INFORMATION (Unaudited)

The following tables set forth certain data from the Company s consolidated statements of income for each of the quarters in the years ended December 31, 2006 and 2005.

The unaudited quarterly consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements contained herein and include all adjustments that the Company considers necessary for a fair presentation of such information when read in conjunction with the Company s annual audited consolidated financial statements and notes thereto appearing elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results for any subsequent period or for the entire fiscal year. Refer to the Annual Report on Form 10-K for the year ended December 31, 2005 for reconciliations to previously filed consolidated statements of income.

	Three Months Ended							
	Dec. 31, 2006	Sept. 30, 2006	June 30, 2006	Mar. 31, 2006(1)	Dec. 31, 2005	Sept. 30, 2005	June 30, 2005	Mar. 31, 2005
	(unaudited) (in thousands, except per share data)							
Net revenues	$ 41,281	$ 44,404	$ 41,465	$ 35,253	$ 37,875	$ 36,543	$ 34,241	$ 34,412
Gross profit	22,109	24,049	24,106	18,345	18,891	18,056	16,625	16,520
Net income (loss)	$ 3,037	$ 2,661	$ 4,506	$ (779)	$ 1,346	$ 5,270	$ 5,038	$ 4,044
Earnings (loss) per share								
Basic	$ 0.11	$ 0.09	$ 0.15	$ (0.03)	$ 0.05	$ 0.18	$ 0.17	$ 0.14
Diluted	$ 0.10	$ 0.09	$ 0.15	$ (0.03)	$ 0.04	$ 0.17	$ 0.16	$ 0.13
Shares used in per share calculation								
Basic	28,658	28,650	29,356	29,582	29,460	29,478	29,423	29,919
Diluted	30,656	29,832	30,955	29,582	30,760	30,849	30,835	30,966

(1) For the three months ended March 31, 2006, the Company had a net loss. Diluted net loss per share is the same as basic net loss per share since the effects of potentially dilutive securities were anti-dilutive for the quarter-ended March 31, 2006.

14. RESTATEMENT OF DECEMBER 31, 2004 CONSOLIDATED FINANCIAL STATEMENTS:

Background

Based upon an investigation and determinations made by a Special Committee of the board of directors and management s undertaking of a separate review of historical stock option activity subsequent to the issuance of the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, the Company identified errors in its accounting related to stock option compensation expense in prior periods. As a result of these errors the Company restated its December 31, 2004 financial statements. The restated financial statements were included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Restatement Adjustments

The Company s restated consolidated financial statements incorporate stock-based compensation expense, payroll tax expense, and other accounting adjustments, including the income tax impacts of the restatement adjustments. The restatement adjustments resulted in an increase of $5.58 million in assets, an increase of $2.34 million in liabilities and a net increase in equity of $3.24 million. Included in the adjustment to net equity is a $29.4 million reduction of retained earnings as of December 31, 2004. This amount includes an increase in the Company s previously reported consolidated net income of approximately $0.1 million for the year ended December 31, 2004.

The following table summarizes the impact of the restatement adjustments on net income for the year ended December 31, 2004 (in thousands):

	2004
As previously reported	$ 20,367
Adjustments:	
Stock compensation expense	(1,288)
Payroll taxes, interest and penalties	1,289
Other miscellaneous accounting adjustments	(107)
Income tax benefit (provision)	239
Total adjustments	133
As adjusted	$ 20,500

35

Table of Contents

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

(in thousands)

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. This allowance is established using estimates formulated by the Company s management based upon factors such as the composition of the accounts receivable aging, historical bad debts, changes in payments patterns, customer creditworthiness, and current economic trends. Following is a summary of the activity in the allowance for doubtful accounts:

Classification	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions(1)	Balance at End of Period
Allowances for doubtful accounts:				
Year ended December 31, 2004	$ 360	$ (84)	$ 5	$ 281
Year ended December 31, 2005	$ 281	$ 67	$ (7)	$ 341
Year ended December 31, 2006	$ 341	$ 79	$ (57)	$ 363

Classification	Balance at Beginning of Period	Charged to Revenue	Deductions(1)	Balance at End of Period
Allowances for customer returns:				
Year ended December 31, 2004	$ 100	$ 645	$ (644)	$ 101
Year ended December 31, 2005	$ 101	$ 525	$ (498)	$ 128
Year ended December 31, 2006	$ 128	$ 341	$ (305)	$ 164

Classification	Balance at Beginning of Period	Charged to Revenue	Deductions(1)	Balance at End of Period
Allowances for ship and debit credits:				
Year ended December 31, 2004	$ 1,900	$ 17,401	$ (16,809)	$ 2,492
Year ended December 31, 2005	$ 2,492	$ 20,006	$ (18,762)	$ 3,736
Year ended December 31, 2006	$ 3,736	$ 48,956	$ (44,488)	$ 8,204

(1) Deductions relate to amounts written off against the allowances for doubtful accounts, customer returns and ship and debit credits.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Amendment to Report to be signed on its behalf by the undersigned, thereunto duly authorized.

	POWER INTEGRATIONS, INC.	
Dated: August 13, 2007	By:	/s/ RAFAEL TORRES Rafael Torres Chief Financial Officer

Table of Contents

INDEX TO EXHIBITS

TO

FORM 10-K ANNUAL REPORT

For the Year Ended

December 31, 2006

EXHIBIT NUMBER	DESCRIPTION
3.1	Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Annual Report on Form 10-K on March 16, 1999, SEC File No. 000-23441.)
3.2	Certificate of Amendment to Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.3 to our Annual Report on Form 10-K on March 22, 2002, SEC File No. 000-23441.)
3.3	Form of Certificate of Designation, Preferences and Rights of the Terms of the Series A Preferred Stock filed as Exhibit A to the Form of Rights Agreement between us and BankBoston N.A., dated February 24, 1999. (As filed with the SEC as Exhibit 1 to our Current Report on Form 8-K on March 12, 1999, SEC File No. 000-23441.)
3.4	Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.1 to our Current Report on Form 8-K on April 22, 2005, SEC File No. 000-23441.)
4.1	Reference is made to Exhibits 3.1 to 3.4.
4.2	Fifth Amended and Restated Rights Agreement by and among us and certain of our investors, dated April 27, 1995. (As filed with the SEC as Exhibit 4.1 to Amendment No. 1 to our Registration Statement on Form S-1 on October 21,1997, SEC File No. 000-23441.)
4.3	Investor s Rights Agreement between us and Hambrecht & Quist Transition Capital, LLC, dated as of May 22, 1996. (As filed with the SEC as Exhibit 4.2 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441.)
4.4	Rights Agreement between us and BankBoston N.A., dated as of February 24, 1999. (As filed with the SEC as Exhibit 1 to our Current Report on Form 8-K on March 12, 1999, SEC File No. 000-23441.)
4.5	Amendment to Rights Agreement between us and BankBoston N.A., dated as of October 9, 2001. (As filed with the SEC as Exhibit 4.3 to our Quarterly Report on Form 10-Q on November 9, 2001, SEC File No. 000-23441.)
10.1	Form of Indemnity Agreement for directors and officers. (As filed with the SEC as Exhibit 10.1 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441.)*
10.2	1988 Stock Option Plan and forms of agreements thereunder. (As filed with the SEC as Exhibit 10.2 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441.)*
10.3	1997 Stock Option Plan (as amended through January 25, 2005) (as filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q on May 6, 2005).*
10.4	1997 Outside Directors Stock Option Plan (as amended through June 6, 2000) (as filed with the SEC as Annex C to our Proxy Statement on April 27, 2000) and forms of agreements thereunder (as filed with the SEC as Exhibit 10.4 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441).*
10.5	1997 Employee Stock Purchase Plan (as amended through June 6, 2000) (as filed with the SEC as Annex B to our Proxy Statement on April 27, 2000) and forms of agreements thereunder (as filed with the SEC as Exhibit 10.5 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441).*

10.6	1998 Nonstatutory Stock Option Plan. (As filed with the SEC as Exhibit 10.30 to our Quarterly Report on Form 10-Q on May 12, 2003, SEC File No. 000-23441.)*
10.7	Chief Executive Officer Benefits Agreement between us and Balu Balakrishnan, dated April 25, 2002. (As filed with the SEC as Exhibit 10.14 to our Quarterly Report on Form 10-Q on May 10, 2002, SEC File No. 000-23441.)*
10.8	Executive Officer Benefits Agreement between us and Derek Bell, dated April 25, 2002. (As filed with the SEC as Exhibit 10.15 to our Quarterly Report on Form 10-Q on May 10, 2002, SEC File No. 000-23441.)*
10.9	Executive Officer Benefits Agreement between us and Bruce Renouard, dated April 25, 2002. (As filed with the SEC as Exhibit 10.17 to our Quarterly Report on Form 10-Q on May 10, 2002, SEC File No. 000-23441.)*
10.10	Executive Officer Benefits Agreement between us and John Tomlin, dated April 25, 2002. (As filed with the SEC as Exhibit 10.19 to our Quarterly Report on Form 10-Q on May 10, 2002, SEC File No. 000-23441.)*
10.11	Executive Officer Benefits Agreement between us and Clifford J. Walker, dated April 25, 2002. (As filed with the SEC as Exhibit 10.20 to our Quarterly Report on Form 10-Q on May 10, 2002, SEC File No. 000-23441.)*
10.12	Loan Agreement between us and Union Bank of California, N.A., dated as of October 16, 1998. (As filed with the SEC as Exhibit 10.23 to our Annual Report on Form 10-K on March 16, 1999, SEC File No. 000-23441.)
10.13	First Amendment to Loan Agreement dated October 16, 1998 between us and Union Bank of California, N.A., dated August 1, 2000. (As filed with the SEC as Exhibit 10.29 to our Quarterly Report on Form 10-Q on November 14, 2000, SEC File No. 000-23441.)
10.14	Wafer Supply Agreement among us and Matsushita Electronics Corporation and Matsushita Electric Industry Co., Ltd., dated as of June 29, 2000. (As filed with the SEC as Exhibit 10.27 to our Quarterly Report on Form 10-Q on November 14, 2000, SEC File No. 000-23441.)
10.15	Technology License Agreement between us and Matsushita Electronics Corporation, dated as of June 29, 2000. (As filed with the SEC as Exhibit 10.28 to our Quarterly Report on Form 10-Q on November 14, 2000, SEC File No. 000-23441.)
10.16	Purchase Agreement among us, SPI HO II Associates, L.P., SPI/TSA Arrowhead, LLC, SPI/TSA Chula Vista L.P. and SPI/Braintree Unit 5 Limited Partnership, dated as of April 21, 2003. (As filed with the SEC as Exhibit 10.33 to our Quarterly Report on Form 10-Q on August 7, 2003, SEC File No. 000-23441.)
10.17	Amended and Restated Wafer Supply Agreement between us and OKI Electric Industry Co., Ltd., dated as of April 1, 2003. (As filed with the SEC as Exhibit 10.31 to our Quarterly Report on Form 10-Q on August 7, 2003, SEC File No. 000-23441.)
10.18	Wafer Supply Agreement between us and ZMD Analog Mixed Signal Services GmbH & CoKG, dated as of May 23, 2003. (As filed with the SEC as Exhibit 10.32 to our Quarterly Report on Form 10-Q on August 7, 2003, SEC File No. 000-23441.)
10.19	Wafer Supply Agreement between us and Matsushita Electric Industrial Co., Ltd., effective as of June 29, 2005. (As filed with the SEC as Exhibit 10.21 to our Current Report on Form 8-K on July 26, 2005, SEC File No. 000-23441.)

10.20	2005 Bonuses; 2006 Bonus Plan, Salaries and Option Grants. (As filed with the SEC in our Current Report on Form 8-K on February 21, 2006, SEC File No. 000-23441.)*
10.21	Agreement to make a one-time payment of $25,000 to each member of the Special Committee. (As filed with the SEC in our Current Report on Form 8-K on March 27, 2006, SEC File No. 000-23441.)*
10.22	Cash Compensation for Non-Employee Directors (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.23	Amendment Number One to the Amended and Restated Wafer Supply Agreement between us and OKI Electric Industry Co., Ltd., effective as of August 11, 2004. (As filed with the SEC as Exhibit 10.22 to our Current Report on Form 8-K on April 18, 2006, SEC File No. 000-23441.)
10.24	Confidential Resignation Agreement and General Release of Claims between us and John Cobb, dated June 15, 2006. (As filed with the SEC as Exhibit 10.1 to our Current Report on Form 8-K on June 20, 2006, SEC File No. 000-23441.)*
10.25	Offer Letter, dated June 30, 2006, between us and Rafael Torres. (As filed with the SEC as Exhibit 10.1 to our Current Report on Form 8-K on July 17, 2006, SEC File No. 000-23441.)*
10.26	Amendment to Offer Letter, dated July 6, 2006, between us and Rafael Torres. (As filed with the SEC as Exhibit 10.2 to our Current Report on Form 8-K on July 17, 2006, SEC File No. 000-23441.)*
10.27	Letter Agreement and accompanying election form regarding officer stock option amendments in connection with Section 409A cure, executed December 15, 2006, between us and Balu Balakrishnan. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.28	Letter Agreement and accompanying election form regarding officer stock option amendments in connection with Section 409A cure, executed December 18, 2006, between us and Derek Bell. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.29	Letter Agreement and accompanying election form regarding officer stock option amendments in connection with Section 409A cure, executed December 22, 2006, between us and Bruce Renouard. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.30	Letter Agreement and accompanying election form regarding officer stock option amendments in connection with Section 409A cure, executed December 21, 2006, between us and John Tomlin. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.31	Letter Agreement and accompanying election form regarding officer stock option amendments in connection with Section 409A cure, executed December 21, 2006, between us and Clifford J. Walker. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.32	Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and Alan Bickell. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.33	Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and Nicholas Brathwaite. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*

Table of Contents

10.34	Acknowledgment and Waiver regarding stock option agreements, dated February 20, 2007, between us and R. Scott Brown. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.35	Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and Alan Bickell. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.36	Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and Nicholas Brathwaite. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.37	Amendment No. 1 to Nonstatutory Stock Option Agreements for Outside Directors, dated February 20, 2007, between us and R. Scott Brown. (As filed with the SEC as the like numbered exhibit to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.38	Approval of payment of 2006 Bonuses to Executive Officers. (As described in our Current Report on Form 8-K filed with the SEC on February 9, 2007, SEC File No. 000-23441.) *
10.39	2006 Bonuses; 2007 Executive Officer Bonus Plan; 2007 Salaries and Target Bonuses. (As described in our Current Report on Form 8-K filed with the SEC on June 8, 2007, SEC File No. 000-23441.) *
10.40	Forms of Option Agreements under the 1997 Stock Option Plan with Executive Officers in connection with the Chief Executive Officer Benefits Agreement and the Executive Officer Benefits Agreements.* (previously filed)
10.41	Forms of Option Agreements under the 1997 Stock Option Plan*(previously filed)
21.1	List of subsidiaries.(previously filed)
23.1	Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm
23.2	Consent of KPMG LLP, Independent Registered Public Accounting Firm
24.1	Power of Attorney (See signature page). (previously filed)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (previously filed)
31.1.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (previously filed)
31.2.1	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** (previously filed)
32.1.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** (previously filed)
32.2.1	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**

Table of Contents

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

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.

* Indicates a management contract or compensatory plan or arrangement.

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