TAIWAN SEMICONDUCTOR MANUFACTURING CO LTD
Form F-3
June 25, 2003

As filed with the Securities and Exchange Commission on June 25, 2003

Registration No. 333-______

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM F-3

REGISTRATION STATEMENT

Under

The Securities Act of 1933

(Exact Name of Registrant as Specified in Its Charter)

Taiwan Semiconductor Manufacturing Company Limited

(Translation of Registrant s Name into English)

Republic of China	**3674**	**Not applicable**
(State or Other Jurisdiction of Incorporation or Organization)	**(Primary Standard Industrial Classification Code Number)**	**(IRS Employer Identification Number)**

No. 8, Li-Hsin Road 6

Science-Based Industrial Park

Hsinchu, Taiwan

(886-3) 563-6688

(Address and Telephone Number of Registrant s Principal Executive Offices)

TSMC North America

2585 Junction Avenue

San Jose, CA 95134, USA

(408) 382-8000

(Name, Address, and Telephone Number of Agent for Service)

With copies to:

John D. Young, Jr., Esq.	**Sebastian R. Sperber, Esq.**
Sullivan & Cromwell LLP	**Cleary, Gottlieb, Steen & Hamilton**
Otemachi First Square, East Tower 16F	**39th Floor, Bank of China Tower**
5-1, Otemachi 1-chome	**One Garden Road, Central**
Chiyoda-ku, Tokyo 100 0004, Japan	**Hong Kong**
81-3-3213-6140	**852-2521-4122**

Approximate date of commencement of proposed sale to the public: As soon as practicable after the Registration Statement becomes effective.

If the only securities being registered on this Form are being offered pursuant to dividend or Interest reinvestment plans, please check the following box. ¨

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, please check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨__________

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨__________

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ¨

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered(1)	Proposed Maximum Offering Price Per Share(2)	Proposed Maximum Aggregate Offering Price(2)	Amount of Registration Fee(3)
Common Shares, par value NT$10 per share(4)	453,809,305 Common Shares	US$ 2.01	US$912,156,703	US$73,793

(1) Includes all common shares represented by American depositary shares initially offered and sold outside the United States but that may be resold from time to time in the United States either as part of the distribution or within 40 days after the later of the effective date of this registration statement and the date the securities are first bona fide offered to the public. The common shares are not being registered for the purpose of sales outside the United States.

(2) Estimated solely for the purpose of determining the amount of the registration fee in accordance with Rule 457(c) under the Securities Act of 1933 on the basis of the average of the high and low prices of the common shares represented by American depositary shares on The New York Stock Exchange on June 24, 2003.

(3) US$257,672 was paid in respect of the then-applicable filing fee of US$240,398 in connection with the initial filing of registrant s registration statement on Form F-3 (File No. 333-14218) on December 21, 2001. Subsequent to the initial filing of such registration statement, due to the retroactive application of the Investor and Capital Markets Fee Relief Act, the applicable filing fee for the initial filing of such registration statement was reduced to US$92,538. An additional US$7,015 required to be paid in connection with the amendment No. 2 to such registration statement on January 30, 2002 was deducted from the US$165,134 overpayment in respect of the filing fee for the initial filing of such registration statement. The additional US$1,773 required to be paid in connection with the registration statement filed pursuant to Rule 462(b) (File No. 333-82050) was paid by deducting from the US$158,119 remaining portion of the overpayment in respect of the filing fee for the initial filing of such registration statement. Pursuant to Rule 457 under the Securities Act, US$73,793 of US$156,346 remaining overpayment by the registrant is hereby applied to pay the filing fee required in connection with this Registration Statement.

(4) American depositary receipts issuable upon deposit of the common shares registered hereby have been registered under a separate registration statement on Form F-6 (File No. 333-14230). Each American depositary share represents five common shares.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

This information in this preliminary prospectus is not complete and may be changed. These securities may not be sold until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell nor does it seek an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to Completion, Dated June 25, 2003

Taiwan Semiconductor Manufacturing Company Limited

(Incorporated as a company limited by shares in the Republic of China)

79,000,000 American Depositary Shares

Representing

395,000,000 Common Shares

This is a global offering of 79,000,000 American depositary shares, or ADSs, of Taiwan Semiconductor Manufacturing Company Limited, or Taiwan Semiconductor. The selling shareholders named on page 27 are selling all of the ADSs being offered in this offering. We will receive the benefit of all of the net proceeds of approximately US$ from the sale of ADSs in this offering by TSMC Partners, Ltd., or TSMC Partners, which is 100% owned by us. We will not receive any proceeds from the sale of ADSs by the other selling shareholders. The ADSs are not being offered in the Republic of China, or ROC. Each ADS represents five common shares, par value NT$10 per share, of Taiwan Semiconductor. The ADSs are evidenced by American depositary receipts, or ADRs.

Our ADSs are listed on The New York Stock Exchange under the symbol TSM . The last reported sale price of the ADSs on The New York Stock Exchange on June 24, 2003 was US$9.97 per ADS. Our outstanding common shares are listed on the Taiwan Stock Exchange under the symbol 2330 . The closing price of our common shares on the Taiwan Stock Exchange on June 24, 2003 was NT$57.00 per share, which is equivalent to approximately US$1.65, assuming an exchange rate of NT$34.60=US$1.00.

See Risk Factors beginning on page 11 to read about factors you should consider before buying the ADSs.

Neither the United States Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the

contrary is a criminal offense.

	Per ADS	Total
Initial price to public	US$	US$
Underwriting discount	US$	US$
Proceeds, before expenses[(1)], to the selling shareholders	US$	US$

(1) The underwriters have agreed to pay certain expenses of Taiwan Semiconductor and the selling shareholders in connection with this offering. For more information, see Underwriting .

The Development Fund, one of our selling shareholders, has granted the underwriters an option exercisable within 30 days from the date of this prospectus to purchase up to an aggregate of 11,761,861 additional ADSs at the initial price to public less the underwriting discount.

The underwriters expect to deliver the ADSs through the book-entry transfer facilities of The Depository Trust Company against payment in U.S. dollars in New York, New York on , 2003.

Goldman Sachs International **Merrill Lynch & Co.**

Prospectus dated June , 2003

THESE SECURITIES MAY NOT BE OFFERED OR SOLD, DIRECTLY OR INDIRECTLY, IN THE REPUBLIC OF CHINA, EXCEPT AS PERMITTED BY APPLICABLE LAW OF THE REPUBLIC OF CHINA.

This prospectus, including the information summarized below, contains translations of some NT dollar amounts into U.S. dollars at specified rates solely for the convenience of the reader. Unless otherwise noted, all translations from NT dollars to U.S. dollars and from U.S. dollars to NT dollars were made at the noon buying rate in The City of New York for cable transfers in NT dollars per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York as of March 31, 2003, which was NT$34.75 to US$1.00. We make no representation that the NT dollar or US dollar amounts referred to herein could have been or could be converted into U.S. dollars or NT dollars, as the case may be, at any particular rate or at all. On June 24, 2003, the noon buying rate was NT$34.60 to US$1.00.

In connection with this offering, Goldman Sachs International and Merrill Lynch, Pierce, Fenner & Smith Incorporated, or any person acting for them, may overallot or effect transactions with a view to supporting the market price of the ADSs and, subject to applicable ROC laws, the common shares at a level higher than that which might otherwise prevail for a limited period of time after the issue date. However, there may be no obligation on Goldman Sachs International, Merrill Lynch, Pierce, Fenner & Smith Incorporated, or their agents, to do this. Such stabilization, if commenced, may be discontinued at any time, and must be brought to an end after a limited period. See Underwriting .

All references in this prospectus to silicon wafer quantities are specified in eight-inch wafer equivalents, unless otherwise specified. When we refer to the capacity of wafer fabrication facilities, we are referring to the installed capacity based on specifications established with the manufacturer of the equipment used in those facilities. We can exceed 100% of these capacity levels through, for example, enhanced productivity beyond that assumed when these specifications were initially established. Unless otherwise specified, the information contained herein assumes that the underwriters overallotment option has not been exercised.

PROSPECTUS SUMMARY

Financial and other information about us is set forth in our annual report on Form 20-F and other documents incorporated herein by reference, copies of which may be obtained as indicated under Where You Can Find More Information .

Our Business

We were founded in 1987 as a joint venture among the ROC government, Koninklijke Philips Electronics N.V. or Philips, and other private investors and were incorporated in the ROC on February 21, 1987. Our common shares have been listed on the Taiwan Stock Exchange since September 5, 1994 and our ADSs have been listed on The New York Stock Exchange since October 8, 1997.

We are the world s largest dedicated semiconductor foundry. As a foundry, we manufacture semiconductors using our advanced production processes for our customers based on their own or third parties proprietary integrated circuit designs. We offer a comprehensive range of leading edge wafer fabrication processes, including processes to manufacture CMOS logic, mixed-signal, radio frequency and embedded memory and BiCMOS mixed-signal and other semiconductors. IC Insights estimates that our revenue market share among dedicated foundries worldwide was 53% in 2001 and 56% in 2002. We also offer design, mask making, probing, testing and assembly services.

We believe that we are the technology leader among the dedicated foundries in terms of net sales of advanced semiconductors with a resolution of 0.18 micron and below, and that we are among the technology leaders in the semiconductor industry generally. For example, we announced the semiconductor industry s first fully functional SRAM chip using 90-nanometer CMOS process technology in March 2002, one year ahead of the International Technology Roadmap for Semiconductors, or ITRS. In April 2002, we unveiled NEXSYS™, the foundry segment s next-generation technology for system-on-chip semiconductor design and manufacturing. In December 2002, we demonstrated the semiconductor industry s first 25-nanometer transistor. This newly designed fin-shaped field-effect transistor, or FinFET, is the first 25-nanometer CMOS transistor to break through critical power barriers, meeting ITRS targets for high-performance operation at this advanced note. In addition, we commenced significant commercial production using 0.13 micron process technology in 2002 and expect to commence commercial production using 90-nanometer in 2003. We also believe that we are a leader in manufacturing process management capabilities among dedicated foundries. We believe our leading position in advanced technology and manufacturing process management capabilities has contributed to our increasing revenue market share among dedicated foundries.

We currently operate one six-inch, six eight-inch and one twelve-inch wafer fabrication plants, or fabs. We have also recently completed the exterior construction of another twelve-inch fab. Our year-end monthly capacity was 381,044 wafers in 2001 and 350,735 in 2002. The decrease in our capacity in 2002 was primarily due to the upgrading of a portion of our 0.35 micron and 0.25 micron capacity into 0.18 micron and 0.15 micron advanced technologies. Based upon preliminary estimates, we expect our monthly capacity to be approximately 375,000 at the end of 2003.

We count among our customers many of the world s leading semiconductor companies, ranging from fabless integrated circuit design houses such as Altera Corporation, Broadcom Corporation, NVIDIA Corporation and VIA Technology, Inc., to integrated device manufacturing companies such as Analog Devices, Inc., Motorola Inc. and Philips, and systems companies. Fabless integrated circuit

1

design houses and integrated device manufacturers accounted for approximately 66% and 33%, respectively, of our net sales in 2001 and 71% and 28%, respectively, of our net sales in 2002.

Our principal executive office is currently located at No. 8, Li-Hsin Road 6, Science-Based Industrial Park, Hsinchu, Taiwan, Republic of China. Our telephone number at that office is (886-3) 563-6688. Our web site is www.tsmc.com. Information contained on our web site does not constitute part of this prospectus.

The Offering

The following information assumes that the underwriters do not exercise the overallotment option granted by the Development Fund to purchase additional ADSs in this offering, unless otherwise indicated. See Selling Shareholders on page 27 for a list of the selling shareholders.

Offering price	US$ per ADS
ADSs offered by the selling shareholders	79,000,000 ADSs
ADSs outstanding after this offering	447,257,552 ADSs
Common shares outstanding after this offering	18,622,886,745 common shares
ADS:common share ratio	1:5
Overallotment option	The Development Fund, one of our selling shareholders, has granted to the underwriters an option exercisable within 30 days from the date hereof to purchase up to an aggregate of 11,761,861 additional ADSs at the initial price to public less the underwriting discount, solely to cover overallotments, if any.
Trading market for the common shares	The only trading market for the common shares is the Taiwan Stock Exchange. The common shares have been listed on the Taiwan Stock Exchange since 1994 under the symbol 2330 .
New York Stock Exchange symbol for ADSs	TSM
ADS Depositary	Citibank, N.A.
Use of proceeds	TSMC Partners intends to use the net proceeds of approximately US$ from the sale of ADSs to fund certain of our employee benefits. We will not receive any proceeds from the sale of ADSs by the other selling shareholders.
Timing and Settlement for the ADSs	We expect that the public offering price of the ADSs will be determined on or about , 2003. The ADSs are expected to be delivered against payment on or about , 2003, which is the third business day following the date of this prospectus. The ADSs will be deposited with a custodian for, and registered in the name of a nominee of, The Depository Trust Company in New York, New York. In general, beneficial interests in the ADSs will be shown on, and transfers of these beneficial interests will be effected only through, records maintained by The Depository Trust Company and its direct and indirect participants, including Euroclear Bank S.A./N.V., as operator of the Euroclear System, and Clearstream Banking, société anonyme.

3

Summary Consolidated Financial Information and Operating Data

The summary financial information below should be read in conjunction with Item 5. Operating and Financial Reviews and Prospects and the consolidated financial statements, notes to the consolidated financial statements and other financial information included in our Form 20-F for the year ended December 31, 2002, incorporated by reference in this prospectus. The summary income statement data and cash flow data for the years ended December 31, 2000, 2001 and 2002, and the summary balance sheet data as of December 31, 2001 and 2002 set forth below are derived from our audited consolidated financial statements included in our Form 20-F for the year ended December 31, 2002, incorporated by reference in this prospectus, and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements, including the notes to these consolidated financial statements. These financial statements have been audited by TN Soong & Co., previously a member firm of Andersen Worldwide, SC, and from April 22, 2002, an associate member firm of Deloitte Touche Tohmatsu. TN Soong & Co. and Deloitte & Touche (Taiwan) combined to establish Deloitte & Touche effective June 1, 2003. The summary income statement data and cash flow data for the years ended December 31, 1998 and 1999 and the summary balance sheet data as of December 31, 1998, 1999 and 2000 set forth below are derived from our audited consolidated financial statements not included in our Form 20-F for the year ended December 31, 2002. The consolidated financial statements set forth below have been prepared and presented in accordance with generally accepted accounting principles in the Republic of China, also called ROC GAAP, which differ in some material respects from generally accepted accounting principles in the United States, also called US GAAP. Please see note 27 to our consolidated financial statements, included in our Form 20-F for the year ended December 31, 2002, incorporated by reference in this prospectus, for a description of the principal differences between ROC GAAP and US GAAP for the periods covered by these financial statements.

	Year ended and as of December 31,					
	1998	1999	2000	2001	2002	2002
	NT$	NT$	NT$	NT$	NT$	US$
	(in millions, except percentages, earnings per share and per ADS, and operating data)					
Income Statement Data:						
ROC GAAP						
Net sales	50,524	76,305	166,198	125,885	162,301	4,677
Cost of sales(1)	(33,009)	(45,212)	(87,610)	(92,228)	(109,988)	(3,170)
Gross profit(1)	17,515	31,093	78,588	33,657	52,313	1,507
Operating expenses(1)	(5,210)	(8,823)	(17,293)	(20,879)	(20,724)	(597)
Income from operations	12,305	22,270	61,295	12,778	31,589	910
Non-operating income	1,977	1,619	6,120	6,476	2,419	70
Non-operating expenses	(3,227)	(3,261)	(3,513)	(8,467)	(6,786)	(196)
Income before income taxes	11,055	20,628	63,902	10,787	27,222	784
Income tax (expense) benefit	2,318	2,383	1,167	3,740	(5,637)	(162)
Net income before minority interest	13,373	23,011	65,069	14,527	21,585	622
Minority interest in loss (income) of subsidiary	1,016	516	37	(44)	25	1
Net income	14,389	23,527	65,106	14,483	21,610	623
Earnings per share(2)	0.92	1.50	3.58	0.75	1.14	0.03
Earnings per ADS equivalent	4.59	7.49	17.92	3.75	5.70	0.16
Average shares outstanding(2)	15,663	15,713	18,163	18,623	18,581	18,581
US GAAP						
Net sales	50,524	76,305	166,860	127,242	162,990	4,697
Cost of sales	(41,200)	(52,163)	(105,359)	(107,194)	(115,374)	(3,325)
Operating expense	(9,525)	(12,310)	(44,472)	(41,712)	(20,764)	(598)
Income (loss) from operations	(201)	11,833	17,029	(21,664)	26,852	774
Income (loss) before income taxes	(2,082)	10,986	20,537	(25,672)	20,210	582
Income tax (expense) benefit	2,316	2,383	1,166	3,741	(5,638)	(162)
Net income (loss)	1,249	13,884	21,740	(21,975)	14,534	419
Cumulative preferred dividends				(455)	(455)	(13)
Income (loss) attributable to common shareholders	1,249	13,884	21,740	(22,430)	14,079	406
Average shares outstanding(3)	15,599	15,674	17,445	18,281	18,543	18,543

4

	Year ended and as of December 31,					
	1998	1999	2000	2001	2002	2002
	NT$	NT$	NT$	NT$	NT$	US$
	(in millions, except percentages, earnings per share and per ADS, and operating data)					
Earnings per share[3]	0.08	0.89	1.25	(1.23)	0.76	0.02
Earnings per ADS equivalent	0.40	4.43	6.23	(6.13)	3.79	0.10
Balance Sheet Data:						
ROC GAAP						
Working capital	15,926	33,267	44,920	37,472	62,175	1,792
Long-term equity investments	6,659	16,165	10,664	11,599	10,635	306
Properties	118,353	150,060	244,748	251,288	246,498	7,104
Goodwill			11,531	11,438	10,159	293
Total assets	165,461	235,436	370,886	366,518	390,542	11,255
Long-term bank borrowing[4]	14,630	22,744	23,339	22,399	11,051	318
Long-term debt payable	22,632	20,000	29,000	24,000	35,000	1,009
Guaranty deposit-in and other liabilities	6,957	6,207	9,046	9,479	8,181	236
Minority interest equity	9,701	7,524	322	120	95	3.0
Total liabilities	59,474	75,341	108,811	89,207	94,594	2,726
Capital Stock	66,472	85,209	129,894	181,326	199,229	5,741
Cash Dividend on common shares	0	0	0	0	0	0
Shareholders equity	96,285	152,571	261,754	277,190	295,853	8,526
US GAAP						
Goodwill			58,348	47,464	47,476	1,368
Total assets	164,784	236,859	407,830	393,990	420,528	12,119
Total liabilities	70,491	84,882	114,884	91,419	96,747	2,788
Mandatory redeemable preferred stock			13,000	13,000	13,000	375
Shareholders equity	94,293	151,977	279,946	289,450	310,623	8,952
Other Financial Data:						
ROC GAAP						
Gross margin	35%	41%	47%	27%	32%	32%
Operating margin	24%	29%	37%	10%	19%	19%
Net margin	28%	31%	39%	12%	13%	13%
Capital expenditures	55,781	51,459	103,762	70,201	55,236	1,592
Depreciation and amortization	15,522	25,198	41,446	55,323	65,001	1,873
Cash provided by operating activities	30,255	40,253	94,786	75,818	98,507	2,839
Cash used in investing activities	(57,436)	(60,952)	(120,949)	(77,232)	(62,190)	(1,792)
Cash provided by (used in) financing activities	16,855	39,518	35,366	897	(6,346)	183
Net cash flow	(10,984)	18,646	9,323	(1,284)	30,234	871
Operating Data:						
Wafers sold[5]	1,184	1,826	3,408	2,159	2,675	2,675
Average utilization rate	74%	97%	106%	51%	73%	73%

(1) Amounts in 1999 and 2000 reflect the reclassification of NT$1,025 million in 1999 and NT$2,072 million in 2000 from cost of sales to research and development.
(2) Retroactively adjusted for all subsequent stock dividends and employee stock bonuses, which have been paid prior to the date hereof.
(3) Retroactively adjusted for all subsequent stock dividends, which have been paid prior to the date hereof.
(4) Excludes debt securities.
(5) In thousands.

RECENT DEVELOPMENTS

As a result of our common shares being listed on the Taiwan Stock Exchange, we are required on an on-going basis to file with The Taiwan Stock Exchange unaudited unconsolidated financial statements as of and for the year-to-date period ending on each of March 31 and September 30. We also regularly release unconsolidated financial statements as of and for the six months ended June 30 and as of and for the year ended December 31. These unconsolidated financial statements are prepared in accordance with generally accepted accounting principles in the Republic of China, also called ROC GAAP, which differ in some material respects from generally accepted accounting principles in the United States, also called US GAAP. For a discussion of the material differences between ROC GAAP and US GAAP, see note 27 to our consolidated financial statements included in our annual report on Form 20-F for the year ended December 31, 2002, which is incorporated herein by reference. In addition, by their nature, unconsolidated financial statements are not comparable in material respects with consolidated financial statements, and should not be compared to the consolidated financial statements for prior periods. Because we have released certain unaudited unconsolidated financial statements for 2003, we are required under applicable rules of the United States Securities and Exchange Commission to include those unaudited unconsolidated financial statements in this prospectus.

The summary income statement data and cash flow data for the three months ended March 31, 2002 and 2003 and the summary balance sheet data as of March 31, 2002 and 2003 set forth below are derived from the unaudited unconsolidated financial statements included in our report on Form 6-K, dated April 30, 2003, which is incorporated herein by reference, and should be read in conjunction with, and is qualified in its entirety by reference to, those unconsolidated financial statements, including the notes to those financial statements. There are no material variations in the accounting principles, practices and methods used in preparing the unaudited unconsolidated financial statements as of and for the three months ended March 31, 2002 and 2003 from U.S. GAAP that are not disclosed in note 27 to our consolidated financial statements included in our annual report on Form 20-F for the year ended December 31, 2002, which is incorporated herein by reference.

The unaudited unconsolidated financial statements, including the information summarized below, do not consolidate the financial position and operations of any of our subsidiaries. Instead, the unconsolidated financial statements account for our investments in our subsidiaries, including TSMC International Investment, our holding company for WaferTech, by using equity method accounting, which differs materially from consolidation. Other differences resulting from nonconsolidation include:

- the level of our bank debt, which is zero on an unconsolidated level because all of our bank debt is borrowed by one or more of our subsidiaries;

- intercompany sales between Taiwan Semiconductor Manufacturing Company Limited and its subsidiaries are not eliminated; and

- individual assets, liabilities, revenue and expenses of unconsolidated subsidiaries are not included in the unconsolidated financial statements.

For a discussion of the accounting policies used in the unaudited unconsolidated financial statements, see note 2 to the unaudited unconsolidated financial statements included in our report on Form 6-K, dated April 30, 2003, which is incorporated herein by reference. Because we account for subsidiaries in our unconsolidated accounts based on the equity method, our unaudited unconsolidated net assets and net income would generally be the same as in our consolidated accounts. Other amounts in other line items may be materially different in our unconsolidated financial statements from our consolidated financial statements. We can give no assurance as to what the relative level of unconsolidated and consolidated assets, net sales, net income or any other financial statement line item will be for the year ended December 31, 2003. In addition, unconsolidated results of operations for the three months ended March 31, 2003 may not be indicative of our unconsolidated or consolidated results of operations for the full year ended December 31, 2003.

Summary Unaudited Unconsolidated Financial Information

	Three months ended and as of March 31,	
	2002	2003
	(unaudited) NT$	(unaudited) NT$
	(in millions, except percentages, earnings per share and per ADS, and operating data)	
Income Statement Data:		
ROC GAAP		
Net sales	35,790	39,325
Cost of sales	(23,763)	(28,939)
Gross profit	12,027	10,386
Operating expenses	(3,845)	(4,191)
Income from operations	8,182	6,195
Non-operating income	632	294
Non-operating expenses	(1,796)	(2,308)
Income before income taxes	7,018	4,180
Income tax (expense) benefit	(430)	178
Net income	6,588	4,358
Earnings per share	0.35	0.23
Earnings per ADS equivalent	1.74	1.14
Average shares outstanding	18,580	18,581
Balance Sheet Data:		
ROC GAAP		
Working capital	62,565	82,638
Long-term equity investments	31,419	34,147
Properties	209,026	205,594
Total assets	357,186	363,263
Long-term bank borrowing(1)		
Long-term debt payable	44,000	35,000
Guaranty deposit-in and other liabilities	9,139	3,750
Total liabilities	75,478	63,378
Shareholders equity	281,709	299,885
Other Financial Data:		
ROC GAAP		
Gross margin	33.6%	26.4%
Operating margin	22.9%	15.6%
Net margin	18.4%	11.1%
Capital expenditures	6,599	9,053
Depreciation and amortization	12,842	15,361
Cash provided by operating activities	20,987	20,129
Cash used in investing activities	(10,800)	(10,317)
Cash (provided by) used in financing activities	14,758	(4,019)
Net cash flow	24,945	5,793

Operating Data:		
Wafers sold[2]	599	694
Average utilization rate	67%	67%

(1) Excludes debt securities. We have borrowed all bank loans through our subsidiaries.
(2) In thousands.

Three Months Ended March 31, 2003 (unaudited) Compared to Three Months Ended March 31, 2002 (unaudited)

Net Sales. Our unconsolidated net sales increased 9.9% from NT$35,790 million in the three months ended March 31, 2002 to NT$39,325 million (US$1,131.7 million) in the three months ended March 31, 2003. This increase was primarily due to an increase in customer demand which resulted in a 15.9% increase in unconsolidated wafer sales volume, from 599 thousand wafers in the first three months of 2002 to 694 thousand wafers in the first three months of 2003, offset in part by a 10.1% decrease in the unconsolidated average selling price of our wafers in U.S. dollar terms. The decrease in the unconsolidated average selling price of our wafers in U.S. dollar terms in the first three months of 2003 was primarily the result of a decline in pure pricing partially offset by a more favorable product mix.

Cost of Sales and Gross Profit. Our unconsolidated cost of sales increased 21.8% from NT$23,763 million in the first three months of 2002 to NT$28,939 million (US$832.8 million) in the first three months of 2003. This increase resulted from higher sales, an increase in unconsolidated depreciation and amortization expenses related to cost of sales from NT$11,620 million in the first three months of 2002 to NT$14,196 million (US$408.5 million) in the first three months of 2003 and an increase in some material and labor costs associated with higher sales. Our unconsolidated depreciation and amortization expenses increased in the first three months of 2003 primarily because of the increased depreciation associated with ramping up Fab 12 (Phase I), and the capacity increases at Fab 6 and Fab 8.

Our unconsolidated gross margin decreased from 33.6% in the first three months of 2002 to 26.4% in the first three months of 2003. The decrease in our gross margin was mainly the result of a decline in average selling prices and the increase in unconsolidated amortization and depreciation expenses in the first three months of 2003.

Operating Expenses. Our total unconsolidated operating expenses increased 9% from NT$3,845 million in the first three months of 2002 to NT$4,191 million (US$120.6 million) in the first three months of 2003. This increase was primarily due to an increase in general and administrative expenses, partially offset by a decrease in marketing expenses and research and development expenses. Unconsolidated general and administrative expenses increased 38.5% from NT$1,007 million in the first three months of 2002 to NT$1,395 million (US$40.1 million) in the first three months of 2003. This increase primarily resulted from (1) a NT$187 million (US$5.4 million) increase in bad debt expenses as a result of the reclassification of the bad debt expenses from unconsolidated marketing expenses to unconsolidated general and administrative expenses, (2) a NT$111 million (US$3.2 million) increase in expenses associated with patent applications as a result of the reclassifications of such expenses from unconsolidated research and development expenses to unconsolidated general and administrative expenses, and (3) a NT$64 million (US$1.8 million) increase in depreciation associated with information technology infrastructure related to expansion of Fab 6 and Fab 12. Unconsolidated marketing expenses decreased 4.7% from NT$298 million in the first three months of 2002 to NT$284 million (US$8.2 million) in the first three months of 2003. This decrease was primarily due to reduced marketing and promotional expenditures. Unconsolidated research and development expenses decreased 1.1% from NT$2,540 million in the first three months of 2002 to NT$2,512 million (US$72.3 million) in the first three months of 2003. We anticipate that our annual research and development expenditures will remain at a similar absolute level in 2003 as in 2002.

Income from Operations. Unconsolidated income from operations decreased 24.3% from NT$8,182 million in the first three months of 2002 to NT$6,195 million (US$178.3 million) in the first three months of 2003. This was primarily due to a 10.1% decline in the unconsolidated average selling price of our wafers in the first three months of 2003. Our unconsolidated operating margin decreased from 23% in the first three months of 2002 to 16% in the first three months of 2003.

Non-Operating Income and Expenses. Unconsolidated non-operating income decreased 53.5% from NT$632 million in the first three months of 2002 to NT$294 million (US$8.5 million) in the first three months of 2003. This decrease principally resulted from a NT$249 million decrease in the net gain on sales of property, plant and equipment and a NT$61 million decrease in premium income from certain of our option contracts. Unconsolidated non-operating expenses increased 28.5% from NT$1,796 million in the first three months of 2002 to NT$2,308 million (US$66.4 million) in the first three months of 2003. This increase principally resulted from NT$570 million increase in investment loss recognized by equity method, a NT$98 million increase in foreign exchange loss and a NT$63 million increase in write-down of idle assets, partially offset by a NT$105 million decrease in casualty loss, a NT$54 million decrease in loss on the disposal of property, plant and equipment, and a NT$41 million decrease in interest expense.

Income Tax Benefit (Expense). In the first three months of 2002 we had an unconsolidated income tax expense of NT$430 million while in the first three months of 2003 we had an unconsolidated income tax benefit of NT$178 million (US$5.1 million). The change was primarily due to a decrease in valuation allowance as a result of the recent tax law changes. In February 2003, the ROC tax authority removed certain restrictions on utilizing tax credits.

Net Income. Unconsolidated net income decreased 33.8% from NT$6,588 million in the first three months of 2002 to NT$4,358 million (US$125.4 million) in the first three months of 2003. This was due principally to a decline in our unconsolidated average selling price for our wafers. Our net margin decreased from 18% for the first three months of 2002 to 11% for the first three months of 2003.

RISK FACTORS

We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. In particular, as we are a non-U.S. company, there are risks associated with investing in our ADSs that are not typical for investments in the shares of U.S. companies. Prior to making an investment decision, you should carefully consider all of the information contained in this prospectus, including the following risk factors.

Risks Relating to Our Business

Since we are dependent on the highly cyclical semiconductor and microelectronics industries, which have experienced significant and sometimes prolonged downturns, our revenues, earnings and margins may fluctuate significantly.

Our semiconductor foundry business is affected by market conditions in the highly cyclical semiconductor and microelectronics industries. Most of our customers operate in these industries. Variations in order levels from our customers result in volatility in our revenues and earnings. From time to time, the semiconductor and microelectronics industries have experienced significant, and sometimes prolonged, downturns. Because our business is, and will continue to be, dependent on the requirements of semiconductor and microelectronics companies for our services, downturns in the semiconductor and microelectronics industries lead to reduced demand for our services. For example, a worldwide slowdown in demand for semiconductor devices in 1998 led to surpluses in capacity and price declines which accelerated rapidly and negatively affected our operating results in 1998. Starting in the first quarter of 2001, the semiconductor and microelectronics industries experienced significant downturns due to a number of factors including a slowdown in the global economy, oversupply in the microelectronics industry, overcapacity in the semiconductor industry and a worldwide inventory adjustment. Due to the significant downturns in the two industries most, if not all, of the integrated device manufacturers that had previously begun purchasing wafer fabrication services from foundry companies reduced purchases from foundry companies. If we cannot take appropriate actions such as reducing our costs to sufficiently offset declines in demand, our revenues and earnings will suffer during downturns. As a result of the 2001 downturn in the semiconductor and microelectronics industries, our net sales and net income for 2001 were 24.3% and 77.8%, respectively, less than the corresponding amounts in 2000. Although the semiconductor and microelectronics industries have recovered to some extent from the 2001 downturn and our net sales and net income for 2002 increased from the corresponding amounts in 2001, we cannot give any assurances that the recovery will continue and if so, for how long.

Overcapacity in the semiconductor industry may reduce our revenues, earnings and margins.

The prices that we can charge our customers for our services are significantly related to the overall worldwide supply of integrated circuits and semiconductor products. The overall supply of semiconductor products is based in part on the capacity of other companies, which is outside of our control. Historically, companies in the semiconductor industry have expanded aggressively during periods of increased demand such as was the case in 2000. As a result, periods of overcapacity in the semiconductor industry have frequently followed periods of increased demand. In a period of overcapacity, if we are unable to offset the adverse effects of overcapacity through, among other things, our technology and product mix, we may have to lower the prices we charge our customers for our services and/or we may have to operate at significantly less than full capacity. Such actions could reduce our margin and weaken our financial condition and results of operations. Due to the decreased annualized demand for semiconductors in 2001 and 2002, our average capacity utilization rate decreased to 51% during 2001 and 73% during 2002 as compared with 106% during 2000.

Decreases in demand and average selling price for end-use applications of semiconductor products may adversely affect demand for our products and may result in a decrease in our revenues and earnings.

A vast majority of our sales revenue is derived from customers who use our products in personal computers, communications devices and consumer electronics. Any significant decrease in the demand for end-use applications of our products may decrease the demand for our products and may result in a decrease in our revenues and earnings. In addition, the historical and continuing trend of declining average selling prices of end-use applications places pressure on the prices of the components that go into these end-use applications. If the average selling prices of end-use applications continue to decrease, the pricing pressure on components produced by us may lead to a reduction of our revenue. If all these events occur at the same time, it could have an adverse effect on our revenues and earnings.

If we are unable to compete effectively in the highly competitive foundry segment of the semiconductor industry, we may lose customers and our profit margin and earnings may decrease.

The markets for our foundry services are highly competitive both in Taiwan and internationally. We compete with other dedicated foundry service providers, as well as integrated device manufacturers. Some of these companies may have access to more advanced technologies and greater financial and other resources than we do. As a result, these companies may be able to compete more aggressively than we could. Moreover, many integrated device manufacturers from time to time allocate a portion of their capacity to contract production of integrated circuits for others, which brings them in direct competition with us. In addition, a number of dedicated foundry service providers have been expanding and we are facing increased competition from them. Increases in competition may decrease our average selling prices, erode our profit margin and weaken our earnings.

If we are unable to remain a technological leader in the semiconductor industry, we may become less competitive and less profitable.

The semiconductor industry and the technologies used are constantly changing. If we do not anticipate these changes in technologies and rapidly develop new and innovative technologies, we may not be able to provide advanced foundry services on competitive terms. If we are unable to maintain the ability to provide advanced foundry services on competitive terms, some of our customers may buy products from our competitors instead of us. As a result, we expect that we will need to offer, on an ongoing basis, increasingly advanced and cost-effective foundry technologies and processes prior to these technologies and processes being offered by our competitors in order to continue to satisfy the increasing requirements of some of our customers. For example, if we are unable on a timely basis to begin offering on a competitive basis commercial production of 90-nanometer semiconductors with all copper interconnects, we may lose to competitors providing advanced technologies certain customers requiring such technologies. In addition, advances in technology typically lead to declining average selling prices for older technologies or processes. As a result, if we cannot reduce the costs associated with using older technologies, the profitability of a given product may decrease over time. If we fail to achieve advances in technology or processes or to obtain access to advanced technologies or processes developed by others, we may become less competitive and less profitable.

If we are unable to manage our expansion and modification of our production facilities effectively, our growth prospects may be limited and our future profitability may be affected.

We have recently been ramping up production at Fab 6 in the Tainan Science-Based Industrial Park (Tainan Science Park), our joint venture fab, Systems on Silicon in Singapore and our first twelve-inch wafer fab, Fab 12 (Phase I), in the Hsinchu Science-Based Industrial Park (Hsinchu Science

Park). We have also recently completed the exterior construction of Fab 14 (Phase I), another twelve-inch fab, in the Tainan Science Park. We are currently monitoring market conditions to determine the appropriate time to move in equipment and commence production at Fab 14 (Phase I).

Since few companies have commenced production operations in the Tainan Science Park, the adequacy of the general infrastructure in the Tainan Science Park when it is fully occupied is uncertain. The failure in the electrical or water systems in the park, for example, would severely hamper the operations of our new fab. Although we have studied the potential effects of vibration from the high speed railway currently planned to pass through the Tainan Science Park and believe that the vibrations will not affect our yield rate for production in the Tainan Science Park, we can give no assurances that our yield will not be negatively affected after the high-speed railway has commenced operation.

Expansion and modification of our production facilities will increase our costs. We will need to purchase additional equipment, train personnel to operate the new equipment or hire additional personnel. We will need to increase our net sales accordingly in order to offset these higher costs. If our customers do not correspondingly increase their purchase of our products and services, our financial performance will be adversely affected.

We may not be able to implement our planned growth or development if we are unable to accurately forecast and sufficiently meet our future capital requirements.

Our capital requirements are difficult to plan in the highly cyclical and rapidly changing semiconductor industry. We will need capital to fund the expansion and modification of our facilities. Future acquisitions or mergers or other developments may also cause us to require additional funds. Our ability to obtain external financing in the future is subject to a variety of uncertainties, including:

- our future financial condition, results of operations and cash flows;
- general market conditions for financing activities by semiconductor companies; and
- economic, political and other conditions in Taiwan and elsewhere.

Therefore, sufficient external financing may not be available to us on a timely basis, on acceptable terms or at all. As a result, we may be forced to curtail our expansion and modification plans or delay the deployment of our services, thereby possibly becoming less competitive, which could result in a loss of customers and limit the growth of our business.

Our business could suffer if we are unable to retain and recruit qualified personnel.

We depend on the continued services of our executive officers and skilled technical and other personnel. Our business could suffer if we lose the services of some of these personnel and we cannot adequately replace them. We will be required to increase the number of employees due to our expansion. We seek to recruit highly qualified personnel and there is intense competition for the services of these personnel in the semiconductor industry. We may not be able to either retain our present personnel or attract additional qualified personnel as and when needed. We expect competition for personnel to increase significantly in the future as new fabless semiconductor companies as well as new semiconductor manufacturing facilities are established. We may need to increase employee compensation levels in order to retain our existing officers and employees and attract and retain the additional personnel that we expect to require.

We may be unable to obtain in a timely manner and at a reasonable cost the equipment necessary for us to remain competitive and we may become less profitable.

The semiconductor manufacturing business is capital intensive and requires investment in expensive equipment manufactured by a limited number of suppliers. The market for equipment used in semiconductor foundries is characterized, from time to time, by intense demand, limited supply and long delivery cycles. Our operations and expansion plans depend on our ability to obtain a significant amount of equipment from a limited number of suppliers. During times of significant demand for this type of equipment, lead times for delivery can be as long as four to ten months or more. As a result, we may be exposed to risks relating to the shortage of required or desired equipment. Shortages of equipment could result in an increase in their prices and longer delivery times. In addition, the expansion and modification of fabs by us and other semiconductor companies may put additional pressure on the supply of equipment. If we are unable to obtain equipment in a timely manner and at a reasonable cost, we may be unable to fulfill our customers orders, which could negatively impact our financial condition and results of operations and cause our profit to decrease.

Our revenue and profitability may decline if we are unable to obtain adequate supplies of raw materials in a timely manner and at reasonable prices.

Our production operations require that we obtain adequate supplies of raw materials, such as silicon wafers, gases and chemicals, and photoresistors, on a timely basis. Shortages in the supply of some materials experienced by the semiconductor industry have in the past resulted in occasional price adjustments and delivery delays. We may not, at certain times, be able to obtain adequate supplies of raw materials in a timely manner and at reasonable prices. Our revenue and earnings could decline if we are unable to obtain adequate supplies of high quality raw materials in a timely manner or if there are significant increases in the costs of raw materials that we could not pass on to our customers.

Our production may be interrupted if we do not have access to sufficient amounts of fresh water.

The semiconductor manufacturing process uses extensive amounts of fresh water. Due to the growth in semiconductor manufacturing capacity in Hsinchu Science Park and Tainan Science Park, the requirements for fresh water in these industrial parks has grown substantially. In 1997, the ROC government constructed a new pipeline in the Hsinchu Science Park to provide companies located there with an additional source of fresh water. In 1997, the ROC government also commenced planning the construction of a fresh water reservoir near Hsinchu Science Park that is expected to satisfy the expected fresh water demands of the Hsinchu region and the Hsinchu Science Park through the year 2021. The construction of the reservoir is expected to be completed in June 2005. Taiwan experiences droughts from time to time. In 2002, Taiwan experienced the worst drought in decades. Although the situation has improved and we have not been adversely affected as a result of previous droughts, until additional water resources are made available on a committed basis, the Hsinchu Science Park may encounter insufficient water supplies. Previous droughts have not, however, impacted the water supplies to the Tainan Science Park. In 2003, there will be a new pipeline constructed to connect reservoirs in Tainan and Kaohsiung to provide additional water supplies to the Tainan Science Park. If there is insufficient water to satisfy our requirements, we may need to reduce our semiconductor production.

The loss of our coverage under certain Philips cross-license arrangements may require us to incur additional expenses to acquire alternative intellectual property rights.

We are the beneficiary of patent cross-licensing arrangements between Koninklijke Philips Electronics N.V., or Philips, and other microelectronics companies. Under the TSMC-Philips

Technology Cooperation Agreement, or TCA, Philips is required to maintain a specified minimum license coverage for our benefit with respect to these cross-licensing agreements. Two of these agreements have expired but are being renegotiated by Philips presently. License rights under several other agreements may either terminate or become limited as to scope in the event that Philips equity ownership falls below a certain percentage generally ranging from 12.5% to 25% and Philips is unable to renegotiate the licenses. In November 2000, Philips purchased from us 1,299,925,653 Preferred A shares, par value NT$10 per share, which were redeemed at par in accordance with their terms on May 29, 2003. As of May 29, 2003, following the redemption by us of the Preferred A shares, Philips, together with its subsidiaries, owned in the aggregate a 21.72% equity interest in us. If we lose certain licensed rights under these arrangements and Philips is not able to renew the licenses, we may not be able to obtain similar licenses without significant expenses. If we are unable to receive any necessary licenses we may need to consider other alternatives including the possible design around of certain of our processes. In the event that Philips is unable to renegotiate the licenses or to provide TSMC with new licenses, then certain terms and conditions of the existing TCA may need to be renegotiated, including the amount of royalty payments to be paid to Philips.

Any inability to obtain, preserve and defend our intellectual property rights could harm our competitive position.

Our ability to compete successfully and to achieve future growth will depend, in part, on our ability to protect our proprietary technologies and to secure on commercially reasonable terms certain technologies that we do not own. We cannot ensure that we will be able to independently develop, or secure from any third party, all of the technologies required for upgrading our production capabilities. Our failure to successfully obtain such technologies may seriously harm our competitive position.

Our ability to compete successfully also depends on our ability to operate without infringing the intellectual property rights of others. We have no means of knowing what patent applications have been filed in the United States or other jurisdictions until they are granted. Because of the complexity of the technologies used and the multitude of patents, copyrights and other overlapping intellectual property rights, it is often difficult for semiconductor companies to determine infringement. Therefore, the semiconductor industry is characterized by frequent litigation regarding patent, trade secret and other intellectual property rights. We have received, from time-to-time, communications from third parties asserting that our technologies, manufacturing processes, the design of the integrated circuits made by us or the use by our customers of semiconductors made by us may infringe their patents or other intellectual property rights. And, because of the nature of the industry, we may continue to receive such communications in the future. In some instances, these disputes have resulted in litigation. In the event any third party were to assert infringement claims against us or our customers, we may have to consider alternatives including, but not limited to:

- Negotiating cross-license agreements using the strength of our patent portfolio to offset any financial costs;
- seeking to acquire licenses to the allegedly infringed patents, which may not be available on commercially reasonable terms, if at all;
- discontinuing using certain process technologies, which could cause us to stop manufacturing certain semiconductors if we were unable to design around the allegedly infringed patents;
- fighting the matter in court and paying substantial monetary damages in the event we were to lose; or
- seeking to develop non-infringing technologies, which may not be feasible.

Any one or several of these developments could place substantial financial and administrative burdens on us and hinder our business. Litigation may also be necessary to enforce our patents or other intellectual property rights. If we fail to obtain certain licenses and if litigation relating to alleged patent infringement or other intellectual property matters occurs, it could prevent us from manufacturing particular products or applying particular technologies, which could reduce our opportunities to generate revenues. See Item 8. Financial Information Legal Proceedings in our Form 20-F, which is incorporated by reference herein, for a further discussion.

If our major shareholders use the majority of our production capacity, we will not be able to service our other customers.

According to our agreement with the Industrial Technology Research Institute of Taiwan, or ITRI, the Ministry of Economic Affairs of the ROC, or an entity designated by the Ministry of Economic Affairs, has an option to purchase up to 35% of our capacity. In addition, if Philips and its affiliates own at least 24.8% of our equity interest, Philips would have an option to require us to sell to Philips 30% of our production capacity. As of May 29, 2003, following the redemption by us of the Preferred A shares, Philips, together with its subsidiaries, owned in the aggregate a 21.72% equity interest in us. If the Ministry of Economic Affairs, or the entity designated by the Ministry of Economic Affairs, exercises its option to any significant degree, or if Philips and its affiliates increase their ownership in us to at least 24.8% of our equity interest and Philips then exercises its option to any significant degree, we may not be able to provide services to all of our other customers unless we are able to increase our capacity accordingly and in a timely manner. Although the Ministry of Economic Affairs has never exercised its option and Philips, during the time when its ownership in us exceeded 24.8% of our equity interest, placed orders with us without recourse to its capacity option, any significant exercise of these options could damage our relationship with our other customers when demand for our services is strong and may encourage them to purchase more products from our competitors in the future.

We are subject to the risk of loss due to explosion and fire because the materials we use in our manufacturing processes are highly flammable.

We use highly flammable materials such as silane and hydrogen in our manufacturing processes and are therefore subject to the risk of loss arising from explosion and fire. The risk of explosion and fire associated with these materials cannot be completely eliminated. Semiconductor companies experience explosion and fire damage from time to time. Although we maintain comprehensive fire insurance up to policy limits, including insurance for loss of property and loss of profit resulting from business interruption, our insurance coverage may not be sufficient to cover all of our potential losses. If any of our fabs were to be damaged or cease operations as a result of an explosion and fire, it would reduce our manufacturing capacity, reduce our revenues and profits and may cause us to lose important customers.

Any impairment charges required under US GAAP may have a material adverse effect on our net income on a US GAAP reconciled basis.

Under currently effective US GAAP, we are required to evaluate our equipment, goodwill and other long-lived assets for impairment whenever there is an indication of impairment. If certain criteria are met, we are required to record an impairment charge. We can give no assurance that impairment charges will not be required in periods subsequent to December 31, 2002. Please see note 27.e. to our consolidated financial statements contained in our Form 20-F, which is incorporated by reference herein, for a discussion of the criteria which, if met, may require impairment charges.

As a result of new standards under US GAAP that became effective on January 1, 2002, we are no longer permitted to amortize the remaining goodwill. Goodwill amortization expenses amounted to

NT$12,051 million under US GAAP for the year ended December 31, 2001. Starting from January 2002, all goodwill must be periodically tested for impairment. As of December 31, 2002, we had NT$47,476 million recorded as goodwill under US GAAP and we found no impairment as of that date. We currently are not able to estimate the extent and timing of any goodwill impairment charge for future years. Any goodwill impairment charge required under US GAAP may have a material adverse effect on our net income for subsequent periods on a US GAAP reconciled basis. Please see note 28.a. to our consolidated financial statements contained in our Form 20-F, which is incorporated by reference herein, for a discussion of the new standard under US GAAP.

The determination of an impairment charge at any given time is based significantly on our expected results of operations over a number of years subsequent to that time. As a result, an impairment charge is more likely to occur during a period when our operating results are otherwise already depressed.

Any significant decrease in sales to one or more of our major customers may decrease our net sales and net income.

The degree to which our sales are concentrated among a limited number of customers is a function of the foundry outsourcing activities of the respective customers in a given fiscal year. Certain of our customers deal with us on the basis as their sole foundry service provider. As we have over half of the market share of the dedicated foundry segment business, our sales concentration is often a reflection of the business activities of a cross section of the semiconductor industry that depend on foundry for wafer outsourcing. Our top ten customers have changed from time to time. In 2001 and 2002, our ten largest customers accounted for approximately 49% and 57% of our net sales, respectively. The increased sales contribution by our top ten customers in 2002 reflected the fact that the selected few customers experienced higher foundry outsourcing business activities than the rest of the customers. Although our top ten customers still accounted for 56% of our net sales in the first quarter of 2003, we believe that our customer base has become more diversified given the changing composition of the top ten customers and a relatively more balanced sales contribution by various customers. While we believe our customer base is strong and diversified, the fact that a relatively limited number of customers constitute a significant portion of our revenue may remain as a business characteristic inherent to our extensive presence in the dedicated foundry segment of the semiconductor market. Our largest customer in 2001 and 2002, NVIDIA Corporation, accounted for approximately 17% of our net sales in 2001 and 20% of our net sales in 2002. In March 2003, NVIDIA announced that it has awarded a long-term contract relating to the production of its latest graphics chips to International Business Machines Corp. NVIDIA simultaneously stated that TSMC would remain its primary foundry partner. There is no assurance that there will not be any loss or cancellation of business from NVIDIA, or from any of our other major customers, in the future. Loss or cancellation of business from our most significant customers, should there be any, could significantly reduce our net sales and net income.

Risks Relating to the ROC

Relations between the ROC and the People s Republic of China could negatively affect our business and the market value of your investment.

Our principal executive offices and our principal production facilities are located in Taiwan and a substantial majority of our net revenues are derived from our operations in Taiwan. The ROC has a unique international political status. The People s Republic of China, or PRC, does not recognize the sovereignty of the ROC. Although significant economic and cultural relations have been established during recent years between the ROC and the PRC, relations have often been strained. The government of the PRC has indicated that it may use military force to gain control over Taiwan in some circumstances, such as a declaration of independence by Taiwan, or foreign power interference in Taiwanese affairs. Past developments in relations between the ROC and the PRC have on occasion depressed the market prices of the securities of Taiwanese companies, including our own. Relations between the ROC and the PRC and other factors affecting military, political or economic conditions in Taiwan could have a material adverse effect on our results of operations, as well as the market price and the liquidity of our ADSs and common shares. Further, the ROC government currently restricts certain types of investments by Taiwanese companies, such as TSMC, in the PRC. Although we have received Phase I approval to establish an 8-inch fabrication plant for producing 0.25 micron semiconductors, we have not applied for Phase II approval (involving the moving of manufacturing equipment from Taiwan to mainland China). Therefore, we cannot assure you that the ROC government will approve our Phase II application.

We are vulnerable to natural disasters which could severely disrupt the normal operation of our business and adversely affect our earnings.

Taiwan is susceptible to earthquakes. On September 21, 1999, Taiwan experienced a severe earthquake that caused significant property damage and loss of life, particularly in the central part of Taiwan. Taiwan also experienced earthquakes in 2000 and 2002. The severe earthquake in September 1999 caused damage to production facilities and adversely affected the operations of many companies in the semiconductor and other industries. We experienced damages to our machinery and equipment as a result of this severe earthquake. There were also interruptions to our production schedule, primarily as a result of power outages caused by the severe earthquake. Most of our production facilities, as well as many of our suppliers and customers and upstream providers of complementary semiconductor manufacturing services, are located in Taiwan. If our customers are affected by an earthquake or other natural disasters such as typhoons, it could result in a decline in the demand for our services. If our suppliers services are affected, our production schedule could be interrupted or delayed. Although we maintain comprehensive natural perils insurance up to policy limits, including insurance for loss of property and loss of profit resulting from business interruption, our insurance coverage may not be sufficient to cover all of our potential losses. As a result, a major earthquake or natural disaster in Taiwan could severely disrupt the normal operation of our business and have a material adverse effect on our financial condition and results of operations.

Fluctuations in exchange rates could result in foreign exchange losses.

Over half of our capital expenditures and manufacturing costs are denominated in currencies other than NT dollars, primarily U.S. dollars, Japanese yen and Euros. A larger portion of our sales are denominated in U.S. dollars and other currencies, than in NT dollars. Therefore, we are particularly affected by fluctuations in the exchange rate between the U.S. dollar and the NT dollar. Any significant fluctuation to our disadvantage in that exchange rate may have an adverse effect on our financial condition. In addition, fluctuations in the exchange rate between the U.S. dollar and the NT dollar will affect the U.S. dollar value of our common shares and the market price of the ADSs and of any cash dividends paid in NT dollars on our common shares represented by ADSs.

The recent outbreak of severe acute respiratory syndrome in Taiwan may materially and adversely affect our business and results of operations.

Since early 2003, mainland China, Hong Kong, Singapore, Taiwan and certain other areas have been experiencing an outbreak of a new and contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. According to the World Health Organization, over 8,400 cases of SARS and 790 deaths had been reported in over 30 countries as of June 12, 2003. We cannot predict at this time the effect this outbreak could have on our company. Potentially, this outbreak may disrupt our operations if any of our employees in any of our fabs is suspected to have

contracted SARS, and the fab is identified as a possible source of spreading SARS infection. We may, under certain circumstances defined by the health authorities, be required to quarantine the suspected employee and employees who have worked closely with the suspected employee and disinfect any affected fab and thus temporarily suspend production at any affected fab. Any quarantine or suspension of production at one or more of our fabs may affect our operations. Furthermore, this outbreak may restrict the level of economic activity in affected areas, which may also adversely affect our business and prospects.

We have taken various prevention measures and established contingency plans to ensure the safety of our employees and of our fabs, and to reduce the adverse impact, if any, in case any of our employees contract SARS. As of June 12, 2003, our prevention measures had been working well and there had been no major impact as a result of SARS on our operations. However, we cannot assure you that the recent outbreak of SARS would not have a material adverse effect on our results of operations.

Risks Relating to ownership of ADSs

Your voting rights as a holder of ADSs will be limited.

Holders of American Depositary Receipts, or ADRs, evidencing ADSs may exercise voting rights with respect to the common shares represented by these ADSs only in accordance with the provisions of our ADS deposit agreement. The deposit agreement provides that, upon receipt of notice of any meeting of holders of our common shares, the depositary bank will, as soon as practicable thereafter, mail to the holders (i) the notice of the meeting sent by us, (ii) voting instruction forms and (iii) a statement as to the manner in which instructions may be given by the holders.

ADS holders will not generally be able to exercise the voting rights attaching to the deposited securities on an individual basis. According to the ROC Company Law, the voting rights attaching to the deposited securities must be exercised as to all matters subject to a vote of shareholders collectively in the same manner, except in the case of an election of directors and supervisors. The election of directors and supervisors is by means of cumulative voting. See Item 10. Additional Information Voting of Deposited Securities in our Form 20-F, which is incorporated by reference herein, for a more detailed discussion of the manner in which a holder of ADSs can exercise its voting rights.

You may not be able to participate in rights offerings and may experience dilution of your holdings.

We may, from time to time, distribute rights to our shareholders, including rights to acquire securities. Under our ADS deposit agreement, the depository bank will not distribute rights to holders of ADSs unless the distribution and sale of rights and the securities to which these rights relate are either exempt from registration under the Securities Act of 1933 with respect to all holders of ADSs, or are registered under the provisions of the Securities Act of 1933. Although we may be eligible to take advantage of certain exemptions for rights offerings by certain foreign companies, we can give no assurances that we can establish an exemption from registration under the Securities Act of 1933, and we are under no obligation to file a registration statement with respect to any such rights or underlying securities or to endeavor to have such a registration statement declared effective. In addition, if the depositary bank is unable to obtain the requisite approval from the Central Bank of China for the conversion of the subscription payments into NT dollars or if the depositary determines that it is unlikely to obtain this approval, we may decide with the depositary bank not to make the rights available to holders of ADSs. See Item 10. Additional Information Foreign Investment in the ROC in our Form 20-F, which is incorporated by reference herein, and Item 10. Additional Information Exchange Controls in the ROC in our Form 20-F, which is incorporated by reference herein.

19

Accordingly, holders of ADSs may be unable to participate in our rights offerings and may experience dilution of their holdings as a result.

If the depositary bank is unable to sell rights that are not exercised or not distributed or if the sale is not lawful or reasonably practicable, it will allow the rights to lapse, in which case you will receive no value for these rights.

The value of your investment may be reduced by possible future sales of common shares or ADSs by us or our shareholders.

Except for the sale of ADSs to the underwriters, the Development Fund has agreed with the underwriters not to dispose of any of our common shares or securities convertible into or exchangeable for common shares, including ADSs, during the period beginning from the date of this prospectus continuing through the date 180 days after the date of this prospectus, except with the prior written consent of the representatives of the underwriters. Both we and the remaining selling shareholders have also agreed, subject to certain exceptions, not to dispose of any of our common shares, including common shares represented by ADSs, during the period beginning from the date of this prospectus continuing through the date 90 days after the date of this prospectus, except with the prior written consent of the representatives of the underwriters. The representatives may, in their discretion, waive or terminate these restrictions. See further   Common Shares Eligible for Future Sale   in this prospectus for a more detailed discussion of restrictions that may apply to future sales of our ADSs or common shares by us and our affiliates.

One or more of our existing shareholders may dispose of significant numbers of common shares or ADSs. One of our two largest shareholders, Philips, sold an aggregate of 24,000,000 ADSs in October 1997. The other largest shareholder, the Development Fund, has also sold significant amounts of common shares and ADSs in the past including 12,094,000 ADSs in November 1998, 12,094,000 ADSs in July 1999, 4,000,000 ADSs in April 2000, 8,680,400 ADSs in June 2000, 14,000,000 ADSs in June 2001, 20,000,000 ADSs in November 2001 and 30,207,200 ADSs in February 2002. The Stabilization Fund also sold 26,800,000 ADSs in February 2002.

In addition, we have in place a conversion sale program that allows some of our shareholders to sell their common shares in ADS form to a specified financial intermediary during a 30-day period not more than once every three months. In the third quarter of 1999, our shareholders sold an aggregate of 5,486,000 ADSs in the program. In the first quarter of 2000, our shareholders sold an aggregate of 6,560,000 ADSs in the program. In the second quarter of 2001, our shareholders sold an aggregate of 11,682,000 ADSs in the program. In the fourth quarter of 2002, our shareholders sold an aggregate of 18,348,000 ADS in the program. We cannot predict the effect, if any, that future sales of ADSs or common shares, or the availability of ADSs or common shares for future sale, will have on the market price of ADSs or common shares prevailing from time to time. Sales of substantial amounts of ADSs or common shares in the public market, or the perception that such sales may occur, could depress the prevailing market price of our ADSs or common shares and could reduce the premium, if any, that the price per ADS on The New York Stock Exchange represents over the corresponding aggregate price of the underlying five common shares on the Taiwan Stock Exchange.

The market value of your investment may fluctuate due to the volatility of, and government intervention in, the ROC securities market.

The Taiwan Stock Exchange has experienced substantial fluctuations in the prices and volumes of sales of listed securities and there are currently limits on the range of daily price movements on the Taiwan Stock Exchange. On March 13, 2000, the Taiwan Stock Exchange Index experienced a 617

point drop, which represented the single largest decrease in the history of the Taiwan Stock Exchange Index. From January 1, 2000 to December 31, 2000, the Taiwan Stock Exchange Index dropped from 8,448.8 to 4,739.0, or 43.9%. On June 24, 2003, the Taiwan Stock Exchange Index closed at 4,909.31.

In response to past declines and volatility in the securities markets in Taiwan, and in line with similar activities by other countries in Asia, the government of the ROC formed the Stabilization Fund, which has purchased and may from time to time purchase shares of Taiwan companies to support these markets. In addition, other funds associated with the ROC government have in the past purchased, and may from time to time purchase, shares of Taiwan companies on the Taiwan Stock Exchange or other markets. In the future, market activity by government entities, or the perception that such activity is taking place, may take place or has ceased, may cause fluctuations in the market prices of our ADSs and common shares.

USE OF PROCEEDS

TSMC Partners intends to use the net proceeds of approximately US$ from the sale of ADSs to fund certain of our employee benefits. We will not receive any proceeds from the sale of ADSs by the other selling shareholders.

WHERE YOU CAN FIND MORE INFORMATION

As required by the United States Securities Act of 1933, we have filed a registration statement on Form F-3 relating to the securities offered by this prospectus with the United States Securities and Exchange Commission, or the SEC. This prospectus is a part of that registration statement, which includes additional information.

We file annual reports on Form 20-F with, and furnish periodic reports on Form 6-K to, the SEC. You may read and copy this information at the SEC s public reference room at Judiciary Plaza, 450 Fifth Street, N.W., Room 1024, Washington, D.C. 20549. You can also request copies of the documents, upon payment of a duplicating fee, by writing to the public reference section of the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room. Our filings with the SEC are also available to the public from the SEC s website at http://www.sec.gov. The SEC website contains reports, proxy and information statements and other information regarding registrants that make electronic filings with the SEC using its EDGAR system. Since November 4, 2002, we have been required to file annual reports on Form 20-F with, and submit reports on Form 6-K and other information to, the SEC through the EDGAR system.

The SEC allows us to incorporate by reference the information we file with the SEC. This means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is considered to be part of this prospectus. Any information that we file later with the SEC and that is deemed incorporated by reference will automatically update and supersede the information in this prospectus. In all such cases, you should rely on the later information over different information included in this prospectus.

This prospectus will be deemed to incorporate by reference the following documents:

- our annual report on Form 20-F for the year ended December 31, 2002, filed on June 23, 2003, to the extent the information in that report has not been updated or superseded by this prospectus;

- our report on Form 6-K, dated April 30, 2003, which contains the unconsolidated interim financial statements as of and for the three months ended, March 31, 2003 and 2002, excluding the report by our independent public accountants contained therein. These unconsolidated financial statements are prepared in accordance with generally accepted accounting principles applicable in the Republic of China, or ROC GAAP, and are not indicative of our consolidated financial position or results of operations;

- any amendment to our annual report on Form 20-F for the year ended December 31, 2002, and any annual report on Form 20-F or amendment thereto filed subsequent to the date hereof and prior to the termination of this offering; and

- any report on Form 6-K submitted by us to the SEC prior to the termination of this offering and identified by us as being incorporated by reference into this prospectus.

You may request a copy of these filings, at no cost, by writing or telephoning us at No.8, Li-Hsin Road 6, Science-Based Industrial Park, Hsinchu, Taiwan, Attention: Wendell Huang or Lilian Lin, telephone number: (8863) 666-5920 or (8863) 666-5939.

We will furnish to Citibank, N.A., as depositary of the ADSs, our annual reports. When the depositary receives these reports, it will upon our request promptly provide them to all holders of record of ADSs. We also will furnish the depositary with all notices of shareholders meetings and other reports and communications that we make available to our shareholders (or English language translations thereof, if necessary). The depositary will make these notices, reports and communications available to holders of ADSs and will upon our request mail to all holders of record of ADSs the information contained in any notice of a shareholders meeting it receives.

You should rely only on the information that we incorporate by reference or provide in this document. We have not authorized anyone to provide you with different information. You should not assume that the information in this document is accurate as of any date other than the date on the front of this document.

MARKET PRICE INFORMATION FOR OUR ADSs AND COMMON SHARES

The principal trading market for our common shares is the Taiwan Stock Exchange. The common shares have been listed on the Taiwan Stock Exchange under the symbol 2330 since September 5, 1994, and the ADSs have been listed on The New York Stock Exchange under the symbol TSM since October 8, 1997. The outstanding ADSs are identified by the CUSIP number 874039100. The table below sets forth, for the periods indicated, the high and low closing prices and the average daily volume of trading activity on the Taiwan Stock Exchange for the common shares and the high and low closing prices and the average daily volume of trading activity on The New York Stock Exchange for the common shares represented by ADSs.

	Taiwan Stock Exchange			New York Stock Exchange[1]		
	Closing price per common share		Average daily Trading volume (in thousands of shares)	Closing price per ADS		Average daily Trading volume (in thousands of ADSs)
	High	Low		High	Low	
	(NT$)	(NT$)		(US$)	(US$)	
2003						
Second Quarter (through June 24, 2003)	59.00	42.20	54,066	10.66	6.90	7,028
June (through June 24, 2003)	59.00	56.00	55,602	10.66	9.54	7,498

(1) Trading in ADSs commenced on October 8, 1997 on The New York Stock Exchange. Each ADS represents the right to receive five common shares.

The ADSs offered in this offering will be fully fungible with, will be identified by the same CUSIP number and will be eligible for trading under the same New York Stock Exchange trading symbol as, the existing ADSs.

As of May 31, 2003, a total of 18,622,886,745 common shares were outstanding.

CAPITALIZATION

The following table sets forth our consolidated capitalization as of March 31, 2003. You should read this table together with our consolidated financial statements contained in our Form 20-F, which is incorporated by reference herein. The as adjusted information adjusts the actual information for:

the appropriation from the earnings of 2002, which was approved by our shareholders as of June 3, 2003 and which is expected to be paid in July 2003, including the stock dividend equivalent to eight common shares per 100 common shares, preferred stock dividend, employee bonus and remuneration to directors and supervisors;

our use of NT$13 billion on May 29, 2003 to redeem all of our then-outstanding Preferred shares; and

the sale of 761,861 ADSs by our wholly owned subsidiary, TSMC Partners, in connection with this offering.

We do not have any unguaranteed and secured long-term debt.

	As of March 31, 2003	
	Actual	**As Adjusted**
	(NT$)	**(NT$)**
	(in thousands)	
Long-term debt (excluding current portion of long-term debt)		
Unguaranteed and unsecured long-term debt	35,000,000	35,000,000
Guaranteed and secured long-term debt	10,181,750	10,181,750
Guaranteed and unsecured long-term debt		
Total long-term debt	45,181,750	45,181,750
Shareholder s equity		
Preferred shares, NT$10 par value	13,000,000	
Common shares, NT$10 par value	186,228,867	202,666,190
Capital surplus	56,839,890	56,848,150
Retained earnings	45,150,064	28,199,257
Unrealized loss on long-term investment	(293,612)	(293,612)
Cumulative translation adjustments	882,749	882,749
Treasury stock	(1,923,492)	(1,667,800)
Total shareholders equity	299,884,466	286,634,934
Total capitalization	345,066,216	331,816,684

SELLING SHAREHOLDERS

All of the ADSs being offered in this offering are being offered by the selling shareholders listed below. In addition, the Development Fund, one of our selling shareholders, has granted to the underwriters an option for 30 days to purchase up to an aggregate of 11,761,861 additional ADSs at the initial price to public per ADS less the underwriting discount solely to cover overallotments, if any. As of May 31, 2003, the selling shareholders held an aggregate of 1,868,453,832 of our common shares, representing 10.03% of the total common shares outstanding. Following this offering, the selling shareholders will own an aggregate of 1,473,453,832 of our common shares, representing 7.91% of the total common shares outstanding (assuming the underwriters do not exercise the overallotment option). The table below sets forth the beneficial ownership of our common shares by each of the selling shareholders prior to this offering and after giving effect to the sale of all of the ADSs offered in this offering.

		Before this offering (as of May 31, 2003)		After this offering (assuming the underwriters do not exercise their option to purchase additional ADSs)		After this offering (assuming the underwriters fully exercise their option to purchase additional ADSs)	
Name	Status/Position	Number of common shares	Percentage of total outstanding common shares	Number of common shares	Percentage of total outstanding common shares	Number of common shares	Percentage of total outstanding common shares
Development Fund[1]	Founding Shareholder	1,793,522,406	9.63%	1,406,831,711	7.55%	1,348,022,406	7.24%
F.C. Tseng	Director and Deputy CEO	30,356,889	0.16%	29,956,889	0.16%	29,956,889	0.16%
Rick Tsai	Director, President and COO	19,191,738	0.10%	18,791,738	0.10%	18,791,738	0.10%
Harvey H.W. Chang	Senior Vice President and CFO	6,384,499	0.03%	5,859,499	0.03%	5,859,499	0.03%
S.H. Lee	Vice President	4,294,842	0.02%	3,444,842	0.02%	3,444,842	0.02%
J.B. Chen	Vice President	5,304,520	0.03%	4,504,520	0.02%	4,504,520	0.02%
M.C. Tzeng	Vice President	3,504,556	0.02%	2,804,556	0.02%	2,804,556	0.02%
Richard L. Thurston	Vice President and General Counsel	250,000	0.00%	225,000	0.00%	225,000	0.00%
Stan Shih	Director	1,835,077	0.01%	1,035,077	0.01%	1,035,077	0.01%
TSMC Partners[2]	100%-owned subsidiary of TSMC	3,809,305	0.02%				

(1) Excludes any common shares that may be owned by other funds controlled by the ROC government.
(2) TSMC Partners holds ADSs rather than common shares.

The principal executive offices of Development Fund are located at 7th Floor, No. 49 Guanchian Road, Taipei, Taiwan, 100, ROC. The offices of Mr. F.C. Tseng, Mr. Rick Tsai, Mr. Harvey H.W. Chang, Mr. S.H. Lee and Mr. Richard L. Thurston are located at No. 8, Li-Hsin Road 6, Science-Based Industrial Park, Hsinchu, Taiwan. The offices of Mr. J.B. Chen and Mr. M.C. Tzeng are located at No. 121, Park Avenue III, Science-Based Industrial Park, Hsinchu, Taiwan. The offices of Mr. Stan Shih are located at 8F, 88, Sec. 1, Hsin Tai Wu Road, Hsichih, Taipei Hsien, Taiwan. The principal executive offices of TSMC Partners are located at TrustNet Chambers, P. O. Box 3444, Road Town, Tortola, British Virgin Islands.

FORWARD-LOOKING STATEMENTS

This prospectus and the documents incorporated by reference in this prospectus contain forward-looking statements that are, by their nature, subject to significant risks and uncertainties. These forward-looking statements include, without limitation, statements relating to:

- our expected development of more advanced process technologies;
- our expected production capacity;
- future developments in the semiconductor industry; and
- our future business development and economic performance.

The words anticipate , believe , estimate , expect , intend , plan and similar expressions, as they relate to us, are intended to ide number of these forward-looking statements. We do not intend to update these forward-looking statements.

The forward-looking statements reflect our current views with respect to future events and are not a guarantee of future performance. Actual results may differ materially from information contained in the forward-looking statements as a result of a number of factors, including, without limitation, the risk factors set forth in this prospectus.

DESCRIPTION OF AMERICAN DEPOSITARY RECEIPTS

Citibank, N.A. is the depositary bank for the ADSs. Citibank s depositary offices are located at 111 Wall Street, New York, New York 10043. ADSs represent ownership interests in securities that are on deposit with the depositary bank. ADSs are normally represented by certificates that are commonly known as ADRs. The depositary bank typically appoints a custodian to safekeep the securities on deposit. In this case, the custodian is Citibank, N.A. Taipei Branch, located at Citicorp Center, 52 Min Sheng East Road, Section 4, Taipei, Taiwan, ROC.

We have appointed Citibank as depositary bank pursuant to a deposit agreement, dated June 7, 2000, entered into among us, Citibank and the holders and owners of beneficial interests in our ADSs, which was amended and restated on , 2003. A copy of the amended and restated deposit agreement is on file with the SEC under cover of a registration statement on Post-Effective Amendment No.1 to Form F-6 filed with the SEC on June 25, 2003. You may obtain a copy of that registration statement that includes a copy of the deposit agreement from the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington D.C. 20549 and from the SEC s website at www.sec.gov.

We are providing you with a summary description of the ADSs and your rights as an owner of ADSs. Please remember that summaries by their nature lack the precision of the information summarized and that a holder s rights and obligations as an owner of ADSs will be determined by the deposit agreement and not by this summary. We urge you to review the deposit agreement in its entirety as well as the form of ADR attached to the deposit agreement.

Each ADS represents five common shares on deposit with the custodian. An ADS will also represent any other property received by the depositary bank or the custodian on behalf of the owner of the ADSs but that has not been distributed to the owners of ADSs because of legal restrictions or practical considerations.

If you become an owner of ADSs, you will become a party to the deposit agreement and therefore will be bound to its terms and to the terms of the ADR that represents your ADSs. The deposit agreement and the ADR specify our rights and obligations as well as your rights and obligations as an owner of ADSs and those of the depositary bank. As a holder of ADSs, you appoint the depositary bank to act on your behalf in certain circumstances. The deposit agreement is governed by New York law. However, our obligations to the holders of common shares will continue to be governed by the laws of the Republic of China, which may be different from the laws in the United States.

As an owner of ADSs, you may hold your ADSs either by means of an ADR registered in your name or through a brokerage or safekeeping account. If you decide to hold your ADSs through your brokerage or safekeeping account, you must rely on the procedures of your broker or bank to assert your rights as an ADS owner. Please consult with your broker or bank to determine what those procedures are. This summary description assumes you have opted to own the ADSs directly by means of an ADR registered in your name and, as such, we will refer to you as the holder , when we refer to you , we assume the reader owns ADSs or will own ADSs at the relevant time.

Dividends and Distributions

As a holder, you generally have the right to receive the distributions we make on the securities deposited with the custodian. Your receipt of these distributions may be limited, however, by practical considerations, legal limitations and the terms of the deposit agreement. Holders will receive such distributions under the terms of the deposit agreement in proportion to the number of ADSs held as of a specified record date.

Distributions of Cash. Whenever we make a cash distribution for the securities on deposit with the custodian, the depositary bank will arrange for the funds to be converted into U.S. dollars and for the distribution of the U.S. dollars to the holders subject to any restrictions imposed by ROC laws and regulations.

The conversion into U.S. dollars will take place only if practicable and only if the U.S. dollars are transferable to the United States. The amounts distributed to holders will be net of the fees, expenses, taxes and governmental charges payable by holders under the terms of the deposit agreement.

Distributions of Shares. Whenever we make a free distribution of common shares for the securities on deposit with the custodian, the depositary bank may, and will upon our request, distribute to holders new ADSs representing the common shares deposited. Only whole new ADSs will be distributed. Fractional entitlements will be sold and the proceeds of such sale will be distributed as in the case of a cash distribution. If additional ADSs are not distributed, the ADS-to-common share ratio will be modified subject to applicable ROC law, in which case each ADS you hold will represent rights and interests in the additional common shares so deposited.

The distribution of new ADSs or the modification of the ADS-to-common share ratio upon a distribution of common shares will be made net of the fees, expenses, taxes and governmental charges payable by holders under the terms of the deposit agreement. In order to pay such taxes or governmental charges, the depositary bank may sell all or a portion of the new common shares so distributed.

No such distribution of new ADSs will be made if it would violate a law (*i.e.*, the U.S. securities laws) or if it is not operationally practicable. If the depositary bank does not distribute new ADSs as described above, it will use its best efforts to sell the common shares received and will distribute the proceeds of the sales as cash.

Distributions of Rights. Whenever we distribute rights to purchase additional common shares, we will assist the depositary bank in determining whether it is lawful and reasonably practicable to distribute rights to purchase additional ADSs to holders.

The depositary bank will establish procedures to distribute rights to purchase additional ADSs to holders if it is lawful and reasonably practicable to make the rights available to holders of ADSs, and if we provide all of the documentation contemplated in the deposit agreement (including opinions to address the legality of the transaction). You may have to pay fees, expenses, taxes and other governmental charges to subscribe for the new ADSs upon the exercise of your rights.

In circumstances in which rights would not otherwise be distributed, if you request the distribution of warrants or other instruments in order to exercise the rights allocable to your ADSs, the depositary bank will make such rights available to you as allowed by applicable law upon written notice from us. Our notice to the depositary bank must indicate that:

- we have elected in our sole discretion to permit the rights to be exercised; and

- you have executed such documents as we have determined in our sole discretion are reasonably required under applicable law.

The depositary bank may sell the rights that are not exercised or not distributed if such sale is lawful and reasonably practicable. The proceeds of such sale will be allocated to the account of the holders otherwise entitled to the rights. If the depositary bank is unable to sell the rights, it will allow the rights to lapse.

Other Distributions. Whenever we distribute property other than cash, common shares or rights in respect of the deposited securities, the depositary bank will determine whether such distribution to holders is feasible. If it is feasible to distribute such property to you, the depositary bank will distribute the property to the holders in a manner it deems practicable. If the depositary bank considers such distribution not to be feasible, it may sell all or a portion of the property received. The proceeds of such a sale will be distributed to holders as in the case of a distribution in cash.

Any distribution will be made net of fees, expenses, taxes and governmental charges payable by holders under the terms of the deposit agreement.

Changes Affecting Common Shares

The common shares held on deposit for your ADSs may change from time to time. For example, there may be a change in nominal or par value, a split-up, consolidation or reclassification of such common shares, or a recapitalization, reorganization, merger, consolidation or sale of assets.

If any such change were to occur, your ADSs would, to the extent permitted by law, represent the right to receive the property received or exchanged in respect of the common shares held on deposit. The depositary bank may in such circumstances deliver new ADSs to you or call for the exchange of your existing ADSs for new ADSs. If the depositary bank may not lawfully distribute such property to you, the depositary bank may sell such property and distribute the net proceeds to you in cash.

Issuance of ADSs upon Deposit of Common Shares

No deposit of common shares may be made into the depositary facility, and no ADSs may be issued against such deposits, without specific ROC regulatory approval, except in connection with (i) dividends on or free distributions of common shares, (ii) the exercise by holders of existing ADSs of their pre-emptive rights in connection with rights offerings or (iii) if permitted under the deposit agreement and the custodian agreement, the purchase directly by any person or through the depositary bank of common shares on the Taiwan Stock Exchange for deposit in the depositary facility; *provided* that the total number of ADSs outstanding after an issuance described in clause (iii) above does not exceed the number of issued ADSs previously approved by the ROC Securities and Futures Commission (plus any ADSs created pursuant to clauses (i) and (ii) above) and subject to any adjustment in the number of common shares represented by each ADS. Under current ROC law, issuances under clause (iii) above will be permitted only to the extent that previously issued ADSs have been cancelled and, for so long as may be required by applicable law, the common shares withdrawn from the depositary facility upon cancellation of such ADSs have been sold. The depositary bank will refuse to accept common shares for deposit pursuant to clause (iii) unless it receives satisfactory legal opinions as described in the deposit agreement. In addition, the depositary bank may, or if so directed by us, will, refuse to accept common shares for deposit whenever we have notified the depositary bank that (i) there are outstanding common shares with rights, including rights to dividends, that are different from the common shares held by the depositary bank, (ii) we have restricted the transfer of these common shares to comply with delivery, transfer or ownership restrictions referred to in the deposit agreement or under applicable law or otherwise or (iii) we have otherwise restricted the deposit of common shares pursuant to the deposit agreement.

The depositary bank may create ADSs on your behalf if you or your broker deposits common shares with the custodian. The depositary bank will deliver these ADSs to the person you indicate only after you pay any applicable fees, charges and taxes payable for the transfer of the common shares to and the issuance and delivery of the ADSs by the depositary bank or custodian.

The issuance of ADSs may be delayed until the depositary bank or the custodian receives confirmation that all required approvals have been given and that the common shares have been duly transferred to the custodian. The depositary bank will only issue ADSs in whole numbers.

When you make a deposit of common shares, you will be responsible for transferring good and valid title to the depositary bank. As such, you will be deemed to represent and warrant that:

- the common shares are duly and validly authorized, issued and outstanding, fully paid and non-assessable and free of any preemptive rights;
- you are duly authorized to deposit the common shares; and
- the common shares are not restricted securities and your deposit of common shares is not restricted by United States federal securities laws and does not violate the deposit agreement.

If any of the representations or warranties are incorrect in any way, we and the depositary bank may, at your cost and expense, take any and all actions necessary to correct the consequences of the misrepresentations.

Certificate of Payment ADSs

In connection with any new issue of common shares by us which will be sold in ADS form, under the terms of the deposit agreement, the depositary bank may issue ADSs representing the certificate of payment that represent the right to receive our newly issued common shares, also called certificate of payment ADSs, rather than ADSs representing our common shares. Certificate of payment ADSs will be treated as ADSs issued under the terms of the deposit agreement except that:

- certificate of payment ADSs will not be fungible with ADSs and will be separately identified until exchanged for ADSs by the depositary bank upon receipt from us of the corresponding number of newly issued common shares;
- holders of certificate of payment ADSs may not withdraw their corresponding interests in the deposited certificate of payment from the ADR facility;
- certificate of payment ADSs shall have different CUSIP numbers than the CUSIP number assigned to the ADSs;
- certificate of payment ADSs will not be exchanged for common shares;
- certificate of payment ADSs will trade on The New York Stock Exchange under the temporary trading symbol to be announced at that time;
- certificate of payment ADSs will only be issued in book-entry form through The Depository Trust Company;

neither certificate of payment ADSs nor interests in the certificate of payment are eligible for pre-release transactions; and

distributions made on certificate of payment ADSs shall be made only on the basis of distributions received in respect of the certificate of payment held by the depositary.

Certificate of payment ADSs will be exchanged automatically for ADSs representing common shares upon receipt by the depositary of share certificates in exchange for certificates of payment.

Withdrawal of Common Shares Upon Cancellation of ADSs

You may withdraw and hold the common shares represented by your ADSs unless you are a citizen of the People s Republic of China, or the PRC, or an entity organized under the laws of the PRC, or request the depositary bank to sell the common shares represented by your ADSs; *provided* that settlement for trading of common shares represented by the ADSs through the book-entry system maintained by the Taiwan Securities Central Depositary Co. Ltd. is permitted. If you are a non-ROC person and elect to withdraw common shares and register as our shareholder, you will be required to appoint a tax guarantor as well as an agent and a custodian in the ROC.

If you or someone on your behalf plans to withdraw common shares from the depositary facility, you would be the recipient of such common shares and (i) you are a related party to us (as defined in the ROC Statements of Financial Accounting Standards No. 6) or (ii) you would be the beneficial owner of 10% or more of our issued common shares previously in the depositary facility, your withdrawal will be subject to ROC governmental disclosure and reporting requirements.

In order to withdraw the common shares represented by your ADSs, you will be required to pay to the depositary the fees for cancellation of ADSs and any charges and taxes payable upon the transfer of the common shares being withdrawn. You assume the risk for delivery of all funds and securities upon withdrawal. Once canceled, the ADSs will not have any rights under the deposit agreement.

If you hold any ADSs registered in your name, the depositary bank may ask you to provide proof of citizenship, residence, tax payer status, exchange control approval, payment of taxes and other governmental charges, compliance with applicable laws and regulations and certain other documents as the depositary bank may deem appropriate before it will effect any withdrawal of the common shares represented by such ADS. The withdrawal of the common shares represented by your ADSs may be delayed until the depositary bank receives satisfactory evidence of compliance with all applicable laws and regulations. If the common shares are withdrawn to or for the account of any person other than the person receiving the proceeds from the sale of ADSs, such evidence may include the disclosure of:

- your name;
- the name and nationality (and the identity number, if such person is a ROC citizen) of any person in whose name the common shares you are withdrawing will be registered;
- the number of common shares such person will receive upon such withdrawal;
- the aggregate number of common shares such person has received upon all withdrawals since the establishment of the depositary facility; and
- any other information that we or the depositary bank may deem necessary or desirable to comply with any ROC disclosure or reporting requirements.

The depositary bank will only accept ADSs for cancellation that represent a whole number of common shares on deposit. If you surrender a number of ADSs for withdrawal representing other than a whole number of common shares the depositary bank will either return the number of ADSs representing any remaining fractional common shares or sell the common shares represented by the ADSs you surrendered and remit the net proceeds of that sale to you as in the case of a distribution in cash. Common shares sold in lots other than integral multiples of 1,000 may realize a lower price on the Taiwan Stock Exchange.

You will have the right to withdraw the securities represented by your ADSs at any time subject to the requirements listed above and:

temporary delays that may arise because (i) the transfer books for the shares or ADSs are closed, or (ii) common shares are immobilized on account of a shareholders meeting, a payment of dividends or rights offering;

obligations to pay fees, taxes and similar charges; and restrictions imposed because of laws or regulations applicable to ADSs or the withdrawal of securities on deposit, including ROC regulations and restrictions which prohibit newly issued shares of ROC companies initially offered in ADS form to be withdrawn from the ADS facility until three months after the initial delivery of the ADSs or during any period in which the custodian holds a certificate of payment in respect of your ADSs, whichever is later.

The deposit agreement may not be modified to impair your right to withdraw the securities represented by your ADSs except to comply with mandatory provisions of law.

Voting Rights

You may direct the exercise of voting rights with respect to the common shares represented by the ADSs only in accordance with the provisions of the deposit agreement as described below and applicable ROC law. See Risk Factors Risks Relating to Ownership of ADSs Your voting rights as a holder of ADSs will be limited .

Except as described below, you will not be able to exercise the voting rights attaching to the common shares represented by your ADSs on an individual basis. According to the ROC Company Law, a shareholder s voting rights attached to shareholdings in an ROC company must, as to all matters subject to a vote of shareholders (other than the election of directors and supervisors, if such election is done by means of cumulative voting), be exercised as to all shares held by such shareholder in the same manner. Accordingly, the voting rights attaching to the common shares represented by ADSs must be exercised as to all matters subject to a vote of shareholders by the depositary bank or its nominee, who represents all holders of ADSs, collectively in the same manner, except in the case of an election of directors and supervisors, if such election is done by means of cumulative voting. Directors and supervisors are elected by cumulative voting unless our Articles of Incorporation stipulate otherwise.

In the deposit agreement, you will appoint the depositary bank as your representative to exercise the voting rights with respect to the common shares represented by your ADSs.

We will provide the depositary bank with copies (including English translations) of notices of meetings of our shareholders and the agenda of these meetings, including an indication of the number of directors or supervisors to be elected if an election of directors or supervisors is to be held at the meeting. The depositary bank has agreed to request and we will, therefore, also provide a list of the candidates who have expressed their intention to run for an election of directors or supervisors. The depositary bank will mail these materials, together with a voting instruction form to holders as soon as practicable after the depositary bank receives the materials from us. In order to validly exercise its voting rights, the holder of ADSs must complete, sign and return to the depositary bank the voting instruction form by a date specified by the depositary bank. Additional or different candidates may be nominated at the meeting of the shareholders than those proposed in the list provided by us and after the depositary bank has mailed the voting instruction form to you. If such change were to occur, the depositary bank may calculate your votes according to procedures not inconsistent with the provisions of the Deposit Agreement, but shall not exercise any discretion regarding your voting rights.

Subject to the provisions described in the second succeeding paragraph, which will apply to the election of directors and supervisors done by means of cumulative voting, if persons together holding at least 51% of the ADSs outstanding at the relevant record date instruct the depositary bank to vote in the same manner in respect of one or more resolutions to be proposed at the meeting (other than the election of directors or supervisors), the depositary bank will notify the instructions to the chairman of our board of directors or a person he may designate. The depositary bank will appoint the chairman or his designated person to serve as the voting representative of the depositary bank or its nominee and

the holders. The voting representative will attend such meeting and vote all the common shares represented by ADSs to be voted in the manner so instructed by such holders in relation to such resolution or resolutions.

If, for any reason, the depositary bank has not by the date specified by it received instructions from persons together holding at least 51% of all the ADSs outstanding at the relevant record date to vote in the same manner in respect of any resolution specified in the agenda for the meeting (other than the election of directors or supervisors done by means of cumulative voting), then the holders will be deemed to have instructed the depositary bank or its nominee to authorize and appoint the voting representative as the representative of the depositary bank and the holders to attend such meeting and vote all the common shares represented by all ADSs as the voting representative deems appropriate with respect to such resolution or resolutions, which may not be in your interests; *provided, however,* that the depositary bank or its nominee will not give any such authorization and appointment unless it has received an opinion of ROC counsel addressed to the depositary bank and in form and substance satisfactory to the depositary bank, at its sole expense, to the effect that, under ROC law (i) the deposit agreement is valid, binding and enforceable against us and the holders and (ii) the depositary bank will not be deemed to be authorized to exercise any discretion when voting in accordance with the deposit agreement and will not be subject to any potential liability for losses arising from such voting. We and the depositary bank will take such actions, including amendment of the provisions of the deposit agreement relating to voting of common shares, as we deem appropriate to endeavor to provide for the exercise of voting rights attached to the common shares at shareholders   meetings in a manner consistent with applicable ROC law.

The depositary bank will notify the voting representative of the instructions for the election of directors and supervisors received from holders and appoint the voting representative as the representative of the depositary bank and the owners to attend such meeting and vote the common shares represented by ADSs as to which the depositary bank has received instructions from holders for the election of directors and supervisors, subject to any restrictions imposed by ROC law and our articles of incorporation. Holders who by the date specified by the depositary bank have not delivered instructions to the depositary bank will be deemed to have instructed the depositary bank to authorize and appoint the voting representative as the representative of the depositary bank or its nominee and the holders to attend such meeting and vote all the common shares represented by ADSs as to which the depositary bank has not received instructions from the holders for the election of directors and supervisors as the voting representative deems appropriate, which may not be in your best interests. Candidates standing for election as representatives of a shareholder may be replaced by such shareholder prior to the meeting of the shareholders, and the votes cast by the holders for such candidates shall be counted as votes for their replacements.

By accepting and continuing to hold ADSs or any interest therein, you will be deemed to have agreed to the voting provisions set forth in the deposit agreement, as such provisions may be amended from time to time to comply with applicable ROC law.

There can be no assurance that you will receive notice of shareholders   meetings sufficiently prior to the date established by the depositary bank for receipt of instructions to enable you to give voting instructions before the cutoff date.

Fees and Charges

As an ADS holder, you will be required to pay the following service fees to the depositary bank:

Service	Fees
Issuance of ADSs	Up to 5¢ per ADS issued
Delivery of deposited securities upon surrender of ADSs	Up to 5¢ per ADS surrendered
Distribution of ADSs pursuant to exercise of rights	Up to 5¢ per ADS issued
Distribution of cash upon sale of rights and other entitlements	Up to 2¢ per ADS held

As an ADS holder, you will also be responsible to pay certain fees and expenses incurred by the depositary bank and certain taxes and governmental charges, such as:

Fees for the transfer, custody and registration of common shares (*i.e.*, upon deposit, transfer and withdrawal of common shares);

Expenses incurred for converting foreign currency into U.S. dollars and in compliance with exchange control regulations;

Expenses for cable, telex and fax transmissions and for delivery of securities; and

Taxes and duties upon the transfer of securities (*i.e.*, when common shares are deposited or withdrawn from deposit).

We have agreed to pay certain other charges and expenses of the depositary bank. Note that the fees and charges you may be required to pay may vary over time and may be changed by agreement between us and the depositary bank. Any change will apply to you 30 days after the depositary bank provides notice of such changes.

Amendments and Termination

We may agree with the depositary bank to modify the deposit agreement at any time without your consent. We undertake to give holders 30 days prior notice of any modifications that would prejudice any of their substantial rights under the deposit agreement (except in very limited circumstances enumerated in the deposit agreement).

You will be bound by the modifications to the deposit agreement if you continue to hold your ADSs after the modifications to the deposit agreement become effective. The deposit agreement cannot be amended to prevent you from withdrawing the common shares represented by your ADSs (except to comply with applicable law).

We have the right to direct the depositary bank to terminate the deposit agreement. Similarly, the depositary bank may in certain circumstances on its own initiative terminate the deposit agreement. In either case, the depositary bank must give notice to the holders at least 60 days before termination.

Upon termination, the following will occur under the deposit agreement:

- for a period of six months after termination, you will be able to request the cancellation of your ADSs and the withdrawal of the common shares represented by your ADSs and the delivery of all other property held by the depositary bank in respect of those common shares on the same terms as prior to the termination. During this six-month period, the depositary bank will continue to collect all distributions received on the common shares on deposit (i.e., dividends) but will not distribute any property to you until you request the cancellation of your ADSs; and

	Year Ended December 31,			
	2010		2009	
Net revenues	$	299.8	$	215.7
Other income	$	1.9	$	1.9
Other income as a % of net revenue		0.6%		0.9%

Other income, net remained flat year over year due primarily to relatively stable interest rates in 2010 compared to 2009.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes. The table below compares the provision for income taxes for the years ended December 31, 2010 and 2009 (dollars in millions):

	Year Ended December 31,	
	2010	2009
Income before provision for income taxes	$ 61.8	$ 30.5
Provision for income taxes	$ 12.3	$ 7.2
Effective tax rate	20.0%	23.8%

Table of Contents

Our effective tax rate was lower than the statutory rate of 35% for the year ended December 31, 2010 due primarily to the geographic distribution of our world-wide earnings, the favorable impacts of the extension of the federal research tax credit for 2010 and the federal investment tax credit on our recent solar-power installation. Our effective tax rate was lower than the statutory rate of 35% for the year ended December 31, 2009 due primarily to the geographic distribution of our world-wide earnings partially offset by the establishment of a partial valuation allowance on our California deferred tax assets.

Outlook for our First Quarter of 2011

In conjunction with the release of our full-year 2010 results on February 3, 2011, we issued the following outlook for the first quarter of 2011:

Quarterly revenues are expected to be between $71 million and $77 million;

Gross margin is expected to be 48 percent plus or minus half a percentage point; and

Operating expenses are expected to be $25 million, plus or minus $0.5 million.

Comparison of Years Ended December 31, 2009 and 2008

Important to understanding our financial results for 2009 and comparing them to our financial results for 2008 is the significant change in stock-based compensation and particularly the impact of our tender offer to purchase employee stock options in 2008. Consequently, we discuss this first before discussing the various line items in our statement of income. Our operating expenses and cost of revenues in 2008 include non-cash, stock-based compensation expenses recognized under ASC 718-20. These non-cash expenses were significantly higher in 2008 as compared to 2009 due primarily to our completion of a tender offer in December 2008, through which we repurchased 2.4 million employee stock options. The tender offer resulted in the recognition of $19.3 million of incremental stock-based compensation expenses in 2008 that would otherwise have been recognized over the remaining vesting periods of the tendered options of up to four years. Total stock-based compensation expense in 2009 was $11.3 million, compared with $35.0 million in 2008, reflecting these accelerated expenses. The table below compares stock-based compensation expenses for 2009 and 2008 (in thousands).

	Year Ended December 31,		
	2009	**2008**	**Change**
Cost of revenues	$ 790	$ 3,481	$ (2,691)
Research & development expense	4,371	11,773	(7,402)
Sales & marketing expense	2,548	11,878	(9,330)
General & administrative expense	3,619	7,832	(4,213)
Total	$ 11,328	$ 34,964	$ (23,636)

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances, plus license fees and royalties. Net revenues increased 7% in 2009 compared with 2008 as a result of growth in the volume of units sold into the consumer, communications and industrial end markets, including applications such as appliances, home entertainment equipment, mobile-phone chargers, LED lights and utility meters. The increase in net revenue did not fully correspond to the increase in unit volume because the product mix included a larger percentage of recently introduced products, which tend to have a lower average sales price than earlier-generation products.

Our net revenue mix by product family and by the end markets served in 2009 and 2008 were as follows:

	Year Ended December 31,	
Product Family	**2009**	**2008**

TinySwitch	43%	44%
LinkSwitch	33%	29%
TOPSwitch	23%	25%
Other	1%	2%

Table of Contents

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

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

Sales to customers outside of the Americas were $204.9 million in 2009 compared to $192.7 million in 2008, representing approximately 95% and 96% of net revenues, respectively. Although the power supplies using our products are designed and distributed worldwide, most of these power supplies are manufactured by our customers in Asia. As a result, sales to this region were 84% and 81% of our net revenues for 2009 and 2008, respectively. We expect international sales to continue to account for a large portion of our net revenues.

Distributors accounted for 64% of our net product sales for the year ended December 31, 2009, while 36% of revenues were from direct sales to end customers. These percentages did not change significantly compared with 2008. In 2009, two distributors, Avnet and ATM Electronic Corporation, accounted for approximately 15% and 10% of our net revenues, respectively. In 2008, Avnet accounted for approximately 16% of our net revenues. No other customers accounted 10% or more of net revenues during these years.

Gross profit. Gross profit is net revenues less cost of revenues. The table below compares gross profit for the years ended December 31, 2009 and 2008 (dollars in millions):

	Year Ended December 31, 2009	2008
Net revenues	$ 215.7	$ 201.7
Gross profit	$ 108.1	$ 105.0
Gross margin	50.1%	52.1%

The decrease in our gross margin in 2009 compared to 2008 was driven by a variety of factors, including: increased sales of recently introduced products, which tend to have a lower gross margin than earlier-generation products; the stronger Japanese yen compared to the U.S. dollar; and lower royalty revenues reflecting the expiration of our royalty agreement with Panasonic in June 2009. These effects were partially offset by a benefit of $0.7 million recognized from the sale of previously reserved inventory, and lower stock based compensation expense in 2009 compared to 2008. Stock based compensation expense was $0.8 million in 2009 compared to $3.5 million in 2008.

Table of Contents

Research and development expenses. The table below compares R&D expenses for the years ended December 31, 2009 and 2008 (dollars in millions):

	Year Ended December 31,	
	2009	2008
Net revenues	$ 215.7	$ 201.7
R&D expenses	$ 30.5	$ 36.9
R&D expenses as a % of net revenue	14.1%	18.3%

R&D expenses were down 17% in 2009 compared with 2008, due primarily to a decline in stock-based compensation expenses, which was partially offset by increased product and technology development expenses. R&D related stock-based compensation expenses were $4.4 million for the year ended December 31, 2009 compared to $11.8 million for the year ended December 31, 2008. The reduction in stock-based compensation expenses was primarily the result of the tender offer conducted in 2008 to repurchase employee stock options, as well as reduced expenses associated with our employee stock purchase plan.

Sales and marketing expenses. The table below compares sales and marketing expenses for the years ended December 31, 2009 and 2008 (dollars in millions):

	Year Ended December 31,	
	2009	2008
Net revenues	$ 215.7	$ 201.7
Sales and marketing expenses	$ 25.0	$ 35.9
Sales and marketing expenses as a % of net revenue	11.6%	17.8%

The 30% decrease in sales and marketing expenses in 2009 compared with 2008 was driven primarily by lower stock-based compensation expenses reflecting the impact of the 2008 tender offer, as well as reduced expenses associated with our employee stock purchase plan. Stock-based compensation expenses for the year ended December 31, 2009 were $2.5 million compared with $11.9 million in 2008. The decrease also reflects general expense reduction efforts undertaken in response to the economic downturn.

General and administrative expenses. The table below compares G&A expenses for the years ended December 31, 2009 and 2008 (dollars in millions):

	Year Ended December 31,	
	2009	2008
Net revenues	$ 215.7	$ 201.7
G&A expenses	$ 24.0	$ 27.3
G&A expenses as a % of net revenue	11.1%	13.5%

The 12% decrease in G&A expenses for the year ended December 31, 2009 compared with the same period in 2008 was primarily the result of lower stock-based compensation expenses reflecting the impact of the 2008 tender offer, as well as reduced expenses associated with our employee stock purchase plan. Stock-based compensation expenses were $3.6 million in 2009 compared to $7.8 million in 2008. The decrease was partially offset by higher legal expenses related to patent litigation; patent-litigation expenses totaled $5.6 million in 2009 compared with $3.4 million in 2008.

Impairment of intangibles. In the fourth quarter of 2008 we concluded that intangible assets related to a certain patent, licensed technology and customer relationships were no longer useful in our manufacturing and sales processes and were therefore impaired. As a result, we recognized a non-cash charge of $2.0 million in the quarter ended December 31, 2008.

Table of Contents

Total other income. Total other income consists primarily of interest income earned on cash and investments. Other income, net totaled $1.9 million in 2009 compared with $7.7 million in 2008. The decrease was due partially to lower interest income on our cash and investments, reflecting lower interest rates available during the year. The decrease in 2009 was also due to an insurance reimbursement of $0.9 million received in 2008 for legal fees related to litigation filed against us and certain of our directors and officers, in connection with an investigation relating to historical stock option grants.

Provision for income taxes. The table below compares the provision for income taxes for the years ended December 31, 2009 and 2008 (dollars in millions):

	Year Ended December 31,	
	2009	**2008**
Income before provision for income taxes	$ 30.5	$ 10.7
Provision for income taxes	$ 7.2	$ 8.9
Effective tax rate	23.8%	83.2%

Our effective tax rate was lower than the statutory rate of 35% for the year ended December 31, 2009 due primarily to the geographic distribution of our world-wide earnings, partially offset by the establishment of a partial valuation allowance on our California deferred tax assets. Our effective tax rate in 2008 was higher than the statutory rate of 35% primarily due to an increase in the relative amount of non-deductible stock-based compensation charges, as well as lower profitability in our foreign jurisdictions with tax rates lower than the U.S. rate. These factors were partially offset by an increase in federal and state research and development tax credits in 2008.

Liquidity and Capital Resources

We had approximately $214.8 million in cash, cash equivalents, short-term and long-term investments at December 31, 2010 compared to $195.6 million at December 31, 2009, and $174.8 million at December 31, 2008.

As of December 31, 2010, 2009 and 2008 we had working capital, defined as current assets less current liabilities, of approximately $212.1 million, $180.0 million and $201.0 million, respectively.

Our operating activities generated cash of $60.0 million, $45.0 million and $36.2 million in the years ended December 31, 2010, 2009 and 2008, respectively. In each of these years, cash was primarily generated from operating activities in the ordinary course of business.

Cash provided by operating activities totaled $60.0 million in the year ended December 31, 2010. Our net income for this period was $49.5 million; we also incurred non-cash depreciation and amortization expenses and stock-based compensation expenses of $13.0 million and $10.7 million, respectively. Additional sources of cash included (i) $16.2 million in decreased accounts receivable associated with improved collections as well as the timing of ship-and-debit credit settlements with distributors and (ii) $5.8 million increase in income tax and other payables. These sources of cash were offset by (i) a $33.6 million increase in inventory due to higher production volumes in response to higher demand for our products along with new product launches; and (ii) an $8.5 million net increase in prepaid expenses and other assets, driven mainly by payment of $10.0 million for a prepaid royalty (for details see Note 11 in Notes to Consolidated Financial Statements).

Cash provided by operating activities totaled $45.0 million in the year ended December 31, 2009. Our net income accounted for $23.3 million of this amount. We recognized $11.3 million and $10.3 million in non-cash expenses related to stock-based compensation and depreciation and amortization expenses, respectively. Changes in operating assets and liabilities resulted in a $1.8 million net use of cash. This included a $10.1 million increase in prepaid expenses and other assets, reflecting a prepaid royalty of $5.3 million, our investment in a third party of $1.2 million, and prepaid legal expenses of $4.0 million, partially offset by other net activity of $0.4 million. Another significant use of cash was an increase in accounts receivable of $8.7 million, reflecting an increase in revenue in December 2009 versus the same period in 2008. Factors increasing our cash provided by operating activities included an increase in accounts payable of $6.8 million, reflecting the timing of payments to our suppliers, an increase in deferred income on sales to distributors of $4.2 million, reflecting increased shipments to our distributors in December 2009 versus December 2008, and an increase in taxes payable and other accrued liabilities of $3.8 million, primarily reflecting increased accrued income taxes.

Cash provided by operating activities totaled $36.2 million in the year ended December 31, 2008. Our net income accounted for $1.8 million of this amount. We recognized $35.0 million and $9.8 million in non-cash expenses related to stock-based compensation and depreciation and amortization expenses, respectively. Significant uses of cash in our 2008 operating activities as a result of changes in operating assets and liabilities included $8.9 million for increased inventories, reflecting lower-than-expected sales of our products in the second half of the year.

Our investing activities for the year ended December 31, 2010 consisted of a $46.5 million net use of cash. This use of cash reflected (i) purchases of property and equipment of $30.6 million, primarily manufacturing equipment to support our increased production requirements, and the installation of a solar array to supply power for our corporate headquarters facility, (ii) $8.6 million to purchase the assets of an early-stage research and development company (see Note 10 in Notes to Consolidated Financial Statements for details), (iii) $6.8 million for the issuance of notes receivable to third parties (see Note 10 in Notes to Consolidated Financial Statements for details), partially offset by $1.4 million of proceeds from the sale of property and equipment.

Our investing activities for the year ended December 31, 2009 consisted of a net $58.0 million use of cash. This use of cash reflected net investment purchases of $53.6 million and purchases of property and equipment of $14.4 million, partially offset by the $10.0 million maturity of our note to our supplier, and the related collection of that note in 2009.

Our investing activities for the year ended December 31, 2008 generated cash of $71.2 million. This was primarily the result of $79.2 million in net proceeds from held-to-maturity investments. We elected not to reinvest these proceeds in order to utilize this cash in our stock-repurchase program, as described below. We used $9.1 million in cash for purchases of property and equipment.

Our financing activities in 2010 resulted in net proceeds of $7.3 million. The proceeds from financing activities included (i) $26.3 million from the issuance of shares through our employee stock purchase plan and the exercise of employee stock options, and (ii) $1.3 million of excess tax benefits from stock options exercised. These sources of cash were partially offset by (i) $14.0 million for the repurchase of our common stock, (ii) $5.6 million for the payment of dividends to stockholders and (iii) $0.8 million for the repurchase and retirement of shares related to employee income tax withholding.

In October 2008, our board of directors authorized the use of $50 million for the repurchase of our common stock. Of this total we utilized $17.7 million during 2009 to repurchase 0.9 million shares, concluding this repurchase program. On May 14, 2009, we announced that our board of directors had authorized the use of up to an additional $25 million for the repurchase of shares of our common stock. From May 14, 2009 to December 31, 2009, we purchased 496,468 shares of our common stock for approximately $11.0 million. In the first two quarters of 2010, 395,915 shares were repurchased for approximately $14.0 million concluding this repurchase program.

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

Table of Contents

In February 2011, we entered into an unsecured credit agreement with a bank (the Credit Agreement). Pursuant to the Credit Agreement, we can request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of $50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. We are required to remain in compliance with certain financial and other covenants.

For advances under the Credit Agreement, interest is due monthly, and principal is due at maturity in February 2013 with prepayments permitted at no penalty. Interest under the Credit Agreement is, at our option, LIBOR plus a 1.5% margin or Prime. We do not pay an undrawn commitment fee. As of the date of this filing, no direct borrowings were outstanding under the Credit Agreement.

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

Our financing activities in 2009 resulted in a net $19.5 million use of cash. The use of cash consisted primarily of the repurchase of approximately 1.4 million shares of our common stock for $28.7 million, the cash payment of $9.0 million to our employees in relation to our tender offer in December 2008, and the $2.7 million payment of dividends to shareholders in 2009. This use of cash was partially offset by $20.3 million in proceeds as a result of exercises of employee stock options and from the issuance of stock through our employee stock purchase plan.

Our financing activities in 2008 resulted in a net use of $58.2 million in cash. In February 2008, we announced that our board of directors had authorized the use of up to $50 million for the repurchase of our common stock. In October 2008, the board of directors authorized the use of an additional $50 million for this purpose. Of this total authorization of $100 million, we utilized $82.4 million during the year to repurchase 4.0 million shares. This use of cash was partially offset by $23.9 million in proceeds from the issuance of stock through our employee stock purchase plan and as a result of exercises of employee stock options. On October 21, 2008, our board of directors declared a quarterly cash dividend of $0.025 cents per share, to be paid to holders of record as of November 28, 2008. This payment resulted in a $0.7 million use of cash on December 31, 2008.

During 2010, a significant portion of our positive cash flow was generated by our operations. If our operating results deteriorate in future periods, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

Off-Balance Sheet Arrangements

As of December 31, 2010 and 2009, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Table of Contents

Contractual Obligations

As of December 31, 2010, we had the following contractual obligations and commitments (in thousands):

		Payments Due by Period			
	Total	Less than 1 Year	1-3 Years	4-5 Years	Over 5 Years
Purchase obligations	$ 18,042	$ 18,042	$	$	$
Operating lease obligations	1,298	660	536	44	58
Total	$ 19,340	$ 18,702	$ 536	$ 44	$ 58

In addition, to our obligations noted above we have a contractual obligation related to income tax as of December 31, 2010, which is comprised primarily of unrecognized tax benefits of approximately $29.9 million, and was classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next year.

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

We entered into an agreement with SemiSouth Laboratories (see Note 11) in 2010 pursuant to which, among other things, we have the option to acquire the company in the future. In addition, we may be obligated to acquire the company at a future date if the company meets certain financial performance conditions. Since it is not possible to estimate the amount and when, or even if, we will exercise our option to acquire the company, or they will exercise their option to put the company to us, or what the purchase price would be, we have not included this future potential payment in the table above.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than one year from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than one year from the balance sheet date are classified as long-term investments. We do not use derivative financial instruments in our investment portfolio to manage our interest rate risk, foreign currency risk, or for any other purpose. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. We do not hold any instruments for trading purposes. At December 31, 2010 and 2009 we held primarily cash equivalents and short-term and long-term investments with fixed interest rates.

Table of Contents

The table below presents the carrying value and related weighted-average interest rates for our investment portfolio at December 31, 2010 and 2009. Carrying value approximates fair market value at December 31, 2010 and 2009 (in thousands, except weighted-average interest rates).

	December 31, 2010		December 31, 2009	
	Carrying Value	Weighted - Average Interest Rate	Carrying Value	Weighted - Average Interest Rate
Investment Securities Classified as Cash Equivalents:				
Commercial paper	$ 7,135	0.44%	$ 40,772	0.60%
U.S. government securities			2,008	0.28
Corporate securities	1,508	0.72		
Total	$ 8,643	0.49%	$ 42,780	0.59%
Investment Securities Classified as Short-term Investments:				
Commercial paper	$		$ 2,848	0.31%
U.S. government securities	5,095	0.95%	15,059	0.35
U.S. municipal securities	1,005	1.00		
Corporate securities	21,255	1.20	2,660	1.51
Total	$ 27,355	1.15%	$ 20,567	0.49%
Investment Securities Classified as Long-term Investments:				
Corporate securities	$ 31,760	2.73%	$ 34,866	2.67%
U.S. government securities			5,234	0.95
Total	$ 31,760	2.73%	$ 40,100	2.44%
Total investment securities	$ 67,758	1.79%	$ 103,447	1.26%

As of December 31, 2010, our overall investment portfolio declined compared to the same period in 2009. We invested a larger portion of cash in money market funds (classified as cash) in 2010 compared to the same period in 2009. We moved our short term investments to money market funds in 2010, as more favorable interest rates were available. Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. To minimize market risk, most of our investments subject to market risk mature in less than one year, and therefore if market interest rates were to increase or decrease by 10% from interest rates as of December 31, 2010 and 2009, the increase or decrease in the fair market value of our portfolio on these dates would not have been material. We monitor our investments for impairment on a periodic basis.

In the event that the carrying value of our investments exceeds its fair value, and we determine the decline in value to be other than temporary, we will reduce the carrying value to its current fair value. As of December 31, 2010 none of our investments were impaired.

Foreign Currency Exchange Risk. We transact business in various foreign countries. Our primary foreign currency cash flows are in Asia and Western Europe and involve a contract with one of our suppliers (OKI). Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts; however, the contract prices to purchase wafers from OKI are denominated in Japanese yen and the agreement allows for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. The purchase price is fixed at a base rate and allows for some sharing of the impact of exchange rate fluctuations from the base rate.

One of our other major suppliers, Epson, contracts prices to purchase wafers in U.S. dollars however, the agreement with Epson also allows for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and Epson review and negotiate pricing; the

Table of Contents

negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between both parties. Nevertheless, changes in the exchange rate between the U.S. dollar and the Japanese yen could subject our gross profit and operating results to the potential for material fluctuations.

Item 8. Financial Statements and Supplementary Data.

The financial statements required by this item are set forth at the pages indicated at Item 15(a), and the supplementary data required by this item is included in Note 14 of the consolidated financial statements.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Not applicable.

Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

Management s Report on Internal Control over Financial Reporting

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

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

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

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

Table of Contents

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

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

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

Changes in Internal Control Over Financial Reporting

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

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Power Integrations, Inc.

San Jose, California

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

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

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s Board of Directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

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

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

San Jose, CA

February 24, 2011

Table of Contents

Item 9B. Other Information.

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

Table of Contents

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The names of our executive officers and their ages, titles and biographies as of the date hereof are incorporated by reference from Part I, Item 1, above.

The following information is included in our Notice of Annual Meeting of Stockholders and Proxy Statement to be filed within 120 days after our fiscal year end of December 31, 2010, or the Proxy Statement, and is incorporated herein by reference:

Information regarding our directors and any persons nominated to become a director, as well as with respect to certain other required board matters, is set forth under Proposal 1 entitled Election of Directors.

Information regarding our audit committee and our designated audit committee financial expert is set forth under the captions Information Regarding the Board and its Committees and Audit Committee under proposal 1 entitled Election of Directors.

Information on our code of business conduct and ethics for directors, officers and employees is set forth under the caption Code of Business Conduct and Ethics under proposal 1 entitled Election of Directors.

Information regarding Section 16(a) beneficial ownership reporting compliance is set forth under the caption Section 16(a) Beneficial Ownership Reporting Compliance.

Information regarding procedures by which stockholders may recommend nominees to our board of directors is set forth under the caption Nominating and Governance Committee under Proposal 1 entitled Election of Directors.

Item 11. Executive Compensation.

Information regarding compensation of our named executive officers is set forth under the caption Compensation of Executive Officers in the Proxy Statement, which information is incorporated herein by reference.

Information regarding compensation of our directors is set forth under the caption Compensation of Directors in the Proxy Statement, which information is incorporated herein by reference.

Information relating to compensation policies and practices as they relate to risk management is set forth under the caption Compensation Policies and Practices as They Relate to Risk Management under Proposal 1 entitled Election of Directors.

Information regarding compensation committee interlocks is set forth under the caption Compensation Committee Interlocks and Insider Participation in the Proxy Statement, which information is incorporated herein by reference.

The Compensation Committee Report is set forth under the caption Compensation Committee Report in the Proxy Statement, which report is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Information regarding security ownership of certain beneficial owners, directors and executive officers is set forth under the caption Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement, which information is incorporated herein by reference.

Information regarding our equity compensation plans, including both stockholder approved plans and non-stockholder approved plans, is set forth under the caption Equity Compensation Plan Information in the Proxy Statement, which information is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Information regarding certain relationships and related transactions is set forth under the caption Certain Relationships and Related Transactions in the Proxy Statement, which information is incorporated herein by reference.

Information regarding director independence is set forth under the caption Proposal 1 Election of Directors in the Proxy Statement, which information is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services.

Information regarding principal auditor fees and services is set forth under Principal Accountant Fees and Services in the Proposal entitled Ratification of Selection of Independent Registered Public Accounting Firm in the Proxy Statement, which information is incorporated herein by reference.

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

2. Financial Statement Schedules

Schedule II: Valuation and Qualifying Accounts.

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

3. Exhibits

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

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Power Integrations, Inc.

San Jose, California

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

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

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

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

San Jose, California

February 24, 2011

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and par value amounts)

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

Total stockholders equity	354,035	284,792
Total liabilities and stockholders equity	$ 433,070	$ 344,567

See accompanying notes to consolidated financial statements.

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

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

See accompanying notes to consolidated financial statements.

48

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

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

Stock-based compensation expense related to employee stock options and awards			9,726			9,726
Stock-based compensation expense related to employee stock purchases			1,123			1,123
Payment of dividends to stockholders					(5,577)	(5,577)
Translation adjustment				81		81
Net income					49,464	49,464
BALANCE AT DECEMBER 31, 2010	28,375	$ 28	$ 175,295	$ 85	$ 178,627	$ 354,035

See accompanying notes to consolidated financial statements.

Table of Contents

POWER INTEGRATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

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

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:						
Accrued payment for employee tender offer	$		$		$	9,048
Unpaid property and equipment	$	5,369	$	785	$	(37)
Application of prepayment to acquisition (Note 10)	$	1,200	$		$	
Conversion of notes receivable in connection with acquisition (Note 10)	$	1,752	$		$	
Conversion of notes receivable in connection with equity investment (Note 11)	$	5,169	$		$	
Acquisition (Note 10)	$	6,955	$		$	
Settlement of pre-existing arrangement in connection with acquisition	$	5,250	$		$	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:						
Cash paid for interest	$	3	$	397	$	9
Cash paid for income taxes, net	$	3,018	$	150	$	5,283

See accompanying notes to consolidated financial statements.

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010

1. THE COMPANY:

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation

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

Estimates

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

Foreign Currency Translation

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

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 maturities of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of December 31, 2010 and December 31, 2009, the Company s short-term and long-term investments consisted of U.S. government-backed securities, municipal bonds, corporate securities, corporate commercial paper and other high-quality commercial securities, which were classified as held-to-maturity and were valued using the amortized-cost method, which approximates fair market value.

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Fair Value of Instruments

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

Inventories

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

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

Total	$ 62,077	$ 26,248

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Account Receivable (in thousands)

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

Prepaid Expenses and Other Current Assets (in thousands)

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

Property and Equipment

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

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

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

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

54

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Goodwill

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

Other Assets (in thousands)

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

Other Accrued Liabilities (in thousands)

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

Employee Benefits Plan

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

Impairment of Long-Lived Assets

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Earnings Per Share

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

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

	Year Ended December 31,		
	2010	**2009**	**2008**
Basic earnings per share:			
Net income	$ 49,464	$ 23,269	$ 1,803
Weighted-average common shares	27,837	26,920	30,099
Basic earnings per share	$ 1.78	$ 0.86	$ 0.06
Diluted earnings per share(1):			
Net income	$ 49,464	$ 23,269	$ 1.803
Weighted-average common shares	27,837	26,920	30,099
Effect of dilutive securities:			
Employee stock plans	1,719	1,377	1,656
Diluted weighted-average common shares	29,556	28,297	31,755
Diluted earnings per share	$ 1.67	$ 0.82	$ 0.06

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Comprehensive Income

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

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

Segment Reporting

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

Revenue Recognition

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

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

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Export Sales

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Product Sales

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

Revenue mix by product family was as follows:

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

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

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

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

Foreign Currency Risk

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Warranty

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

Advertising

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

Research and Development

Research and development costs are expensed as incurred.

Income Taxes

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

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

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

Common Stock and Common Stock Dividends

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Stock-Based Compensation

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

Determining Fair Value of Stock Options

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

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

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

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

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

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company has cash investment policies that limit cash investments to low risk investments. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers financial condition and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past losses and other relevant information. Account balances are recorded against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. As of December 31, 2010 and 2009, approximately 76% and 63% of accounts receivable, respectively, were concentrated with ten customers. As of December 31, 2010 and 2009, one customer, a distributor of the Company s products, accounted for more than 10% of accounts receivable. No other customers accounted for more than 10% of accounts receivable in the periods mentioned.

Indemnifications

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

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

Recently Issued Accounting Pronouncements

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

3. COMMITMENTS AND CONTINGENCIES:

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

Facilities

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Purchase Obligations

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

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

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

Lease line

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

4. FAIR VALUE MEASUREMENTS:

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

	Fair Value Measurement Using Significant Unobservable Inputs (Level 3) Note Receivables

Beginning balance at January 1, 2010	$	
Issuances		6,750
Conversion in connection with acquisition (see Note 10)		(1,750)
Conversion to cost-method investment (see Note 11)		(5,000)
Ending balance at December 31, 2010	$	

65

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. STOCK PLANS AND SHARE BASED COMPENSATION:

Preferred Stock

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

Stock Plans

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

2007 Equity Incentive Plan

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

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

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

1997 Stock Option Plan

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the 1997 Plan), whereby the board of directors may grant incentive stock options and nonstatutory stock options to key employees, directors and consultants to purchase the Company s common stock. The exercise price of incentive stock options may not be less than 100% of the fair market value of the Company s common stock on the date of grant. The exercise

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

price of nonstatutory stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. The 1997 Plan originally provided that the number of shares reserved for issuance automatically increased on each January 1st, from January 1, 1999 through January 1, 2007, by 5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. In January 2005, the board of directors amended the 1997 Plan to reduce the annual increase from 5% to 3.5%, so that the number of shares reserved for issuance automatically increases on each January 1st, from January 1, 2006 through January 1, 2007, by 3.5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. Effective November 2007, the board of directors determined that no further options would be granted under the 1997 Plan, and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options under the 1997 Plan were transferred to the 2007 Equity Incentive Plan. All outstanding options would continue to be governed and remain outstanding in accordance with their existing terms.

1997 Outside Directors Stock Option Plan

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

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

1998 Nonstatutory Stock Option Plan

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee s compensation, to the purchase of shares of the Company s common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company s common stock on the first day of each offering period, or (ii) the fair market value of the Company s common stock on the purchase date (as defined in the Purchase Plan). Prior to February 1, 2009, each offering period consisted of four consecutive purchase periods of approximately six months duration, or such other number or duration as the board determined. Beginning February 1, 2009, each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of December 31, 2010, 2,220,875 shares had been purchased and 779,125 shares were reserved for future issuance under the Purchase Plan.

Stock-based Compensation

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

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Performance-based Awards

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Restricted Stock Units (RSUs)

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Non-employee Stock Options

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

Shares Reserved

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

6. TENDER OFFER:

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

7. TAXES:

Income Taxes

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

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

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

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Unrecognized Tax Benefits

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

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

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

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

8. GOODWILL, INTANGIBLE ASSETS AND ASSET IMPAIRMENT:

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

9. LEGAL PROCEEDINGS:

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

The Company is also subject to a variety of other claims and suits that arise from time to time in the ordinary course of business. These matters are subject to inherent uncertainties and the Company s view of these matters may change in the future and could result in charges that would have a material adverse impact on its financial position, results of operations, or cash flows.

10. ACQUISITIONS:

On February 26, 2010, the Company entered into a definitive agreement to purchase the assets of an early-stage research and development company involved in developing certain technology that is consistent with our long-term business strategy for cash totaling $11.5 million. As of December 31, 2009, the Company had provided $1.2 million toward the purchase price; this amount was included in other assets in the

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company s consolidated balance sheet at December 31, 2009. In the second quarter of 2010, the Company also provided to this early-stage company a loan of $1.8 million, which was to be repaid upon closing of the acquisition. The Company accounted for the transaction as an acquisition of a business and completed the acquisition on August 26, 2010. Upon closing, the Company paid cash of $8.8 million, applied the prepayment of $1.2 million, and converted the above-mentioned $1.8 million loan to complete the acquisition. The Company allocated $6.2 million of the purchase price to goodwill, which is deductible for tax purposes (see Note 8), $4.7 million to in-process research and development, which the Company will amortize over the estimated life of the technology upon completion of its development (see Note 8 above), and $0.6 million to fixed assets. The Company also expensed $0.4 million of acquisition-related costs which were recorded as general and administrative expense in 2010. Goodwill recognized in the acquisition of this early-stage research and development company was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce.

In 2009 the Company entered into an agreement with Qspeed Semiconductor, a supplier of high-performance, high-voltage diodes, pursuant to which, among other things, it may have been obligated to acquire Qspeed Semiconductor if the company met certain financial performance conditions. During the second quarter of 2009, the Company also entered into a license agreement with Qspeed Semiconductor for the use of its technology in exchange for a prepaid royalty of $5.25 million. On December 31, 2010, the Company acquired certain assets of Qspeed Semiconductor for approximately $7.0 million in cash. As of December 31, 2010, the $7.0 million to be paid in connection with the acquisition was reflected in other accrued liabilities in the Company s balance sheet. The Company accounted for the transaction as an acquisition of a business.

The Company s acquisition of Qspeed Semiconductor effectively settled the preexisting license agreement. Because the terms of the license agreement were determined to represent fair value at the acquisition date, the Company did not record any gain or loss separately from the acquisition and the $5.25 million unamortized prepaid royalty was included as part of the acquisition-date fair value of consideration transferred.

Fair value consideration consists of the following (in thousands):

Cash	$ 6,955
Settlement of preexisting arrangement	5,250
Total	$ 12,205

Of the total consideration transferred, $6.8 million was allocated to goodwill, which is deductible for tax purposes, $1.8 million was allocated to developed technology, $0.9 million was allocated to customer relationships, $0.4 million was allocated to fixed assets, $2.1 million was allocated to inventory, including $0.6 million of inventory mark up, which will be amortized to cost of revenues over the next twelve months, and $0.2 million was allocated to accounts receivable. Goodwill recognized in the acquisition of Qspeed Semiconductor was derived from expected benefits from future technology, cost synergies and a knowledgeable and experienced workforce. The allocation of the purchase price is preliminary and may be adjusted should further information regarding events or circumstances existing at the acquisition date become available.

The accompanying Consolidated Financial Statements for fiscal year 2010 include the operations of the aforementioned acquisitions, commencing as of the acquisition dates. No supplemental pro forma information is presented for the acquisitions due to the immaterial effect of the acquisitions on the Company s results of operations both individually and in the aggregate.

Table of Contents

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INVESTMENT IN THIRD PARTY:

On October 22, 2010, the Company made a $7.0 million equity investment in SemiSouth Laboratories (SemiSouth). The Company accounts for its non-marketable investment in SemiSouth under the cost method as the Company has less than a 20% ownership interest in SemiSouth and does not have the ability to exercise significant influence over the investee. Prior to the equity investment the Company had provided three notes to SemiSouth Laboratories, the first on May 27, 2010, the second on August 27, 2010 and the third on September 29, 2010, for $3.0 million, $1.0 million and $1.0 million, respectively. These notes including earned interest were converted into equity upon execution of the agreement, and an additional $1.8 million in cash was paid to the company on October 22, 2010, to fund the equity investment. The Company also paid $10.0 million as a prepaid royalty in exchange for the right to use SemiSouth Laboratories technology. The Company will amortize the royalty to cost of revenues based on the Company s sales of products incorporating the licensed technology. Subsequent to December 31, 2010, the Company entered into an agreement with SemiSouth Laboratories to provide a lease line for the financing of capital equipment. Under the term of the agreement, SemiSouth Laboratories can borrow up to $15.5 million through January 2013 (see Note 4). In connection with entering into these agreements, the Company entered into an agreement pursuant to which, among other things, it may be obligated to acquire SemiSouth Laboratories if it meets certain financial performance conditions.

The Company accounts for its non-marketable investment in SemiSouth Laboratories under the cost method. The investment is periodically reviewed for other-than-temporary declines in fair value by considering available evidence, including general market conditions, the company s financial condition, pricing in recent rounds of financing, earnings and cash flow forecasts, recent operational performance and any other readily available market data. The carrying value of the Company s investment in SemiSouth Laboratories is $7.0 million and was classified within other assets on the Company s consolidated balance sheet as of December 31, 2010. The Company did not recognize any impairment loss during the year ended December 31, 2010.

12. SUPPLIER AGREEMENT:

The Company entered into a wafer supply agreement amendment with one of its foundries in the third quarter of 2008, which amends its previous agreement with the foundry. The amended agreement includes a Company prepayment of $3.1 million for raw materials. Purchases of raw material under this agreement will be made based upon future production build plans of the Company s wafers. As of December 31, 2010, $0.9 million remained as prepaid, and as of December 31, 2009, $2.9 remained prepaid under this agreement. The Company included the prepayment in prepaid expenses and other current assets in its December 31, 2010 and 2009 consolidated balance sheets.

13. SUBSEQUENT EVENTS:

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

In February 2011, the Company entered into an agreement with SemiSouth Laboratories to provide a lease line of up to $15.5 million for the financing of capital equipment. As of the date of this filing, $3.8 million had been funded under this arrangement.

In February 2011, the Company entered into an unsecured credit agreement with a bank (the Credit Agreement). Pursuant to the Credit Agreement, the Company can request, from time to time until February 2013,

POWER INTEGRATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

advances in an amount not to exceed an aggregate principal amount of $50.0 million, the proceeds of which can be used for working capital requirements and other general corporate purposes. The Company is required to remain in compliance with certain financial and other covenants.

For advances under the Credit Agreement, interest is due monthly, and principal is due at maturity in February 2013 with prepayments permitted at no penalty. Interest under the Credit Agreement is, at our option, LIBOR plus a 1.5% margin or Prime. We do not pay an undrawn commitment fee. As of the date of this filing, no direct borrowings were outstanding under the Credit Agreement.

14. 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, 2010 and 2009.

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.

	Three Months Ended (unaudited)							
	Dec. 31, 2010	**Sept. 30, 2010**	**June 30, 2010**	**Mar. 31, 2010**	**Dec. 31, 2009**	**Sept. 30, 2009**	**June 30, 2009**	**Mar. 31, 2009**
	(in thousands, except per share data)							
Net revenues	$ 72,986	$ 75,452	$ 79,858	$ 71,507	$ 66,138	$ 60,024	$ 49,250	$ 40,289
Gross profit	36,125	39,005	41,489	35,922	33,816	29,123	24,197	20,932
Net income	$ 8,929	$ 12,634	$ 15,587	$ 12,314	$ 9,184	$ 9,152	$ 4,529	$ 404
Earnings per share								
Basic	$ 0.32	$ 0.45	$ 0.56	$ 0.45	$ 0.34	$ 0.34	$ 0.17	$ 0.01
Diluted	$ 0.30	$ 0.43	$ 0.53	$ 0.42	$ 0.32	$ 0.32	$ 0.16	$ 0.01
Shares used in per share calculation								
Basic	28,134	27,894	27,844	27,470	27,106	26,723	26,804	27,048
Diluted	29,844	29,283	29,535	29,358	29,116	28,431	27,944	28,057

Table of Contents

Schedule II

Valuation and Qualifying Accounts

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 debt, changes in payments patterns, customer creditworthiness, and current economic trends. The Company maintains an allowance for the distributors ship and debit credits relating to the sell-through of the Company s products. This reserve is established using the Company s historical ship and debit amounts and levels of inventory in the distributor channels.

Following is a summary of the activity in the allowance for doubtful accounts and allowance for ship and debit credits:

Classification (in thousands)	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, 2008	$ 261	$ 45	$ 0	$ 306
Year ended December 31, 2009	$ 306	$ (4)	$	$ 302
Year ended December 31, 2010	$ 302	$ 1	$ (28)	$ 275

Classification (in thousands)	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions(1)	Balance at End of Period
Allowances for ship and debit credits:				
Year ended December 31, 2008	$ 9,721	$ 64,916	$ (65,170)	$ 9,467
Year ended December 31, 2009	$ 9,467	$ 70,484	$ (62,984)	$ 16,967
Year ended December 31, 2010	$ 16,967	$ 130,993	$ (123,479)	$ 24,481

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

86

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 report to be signed on its behalf by the undersigned, thereunto duly authorized.

	POWER INTEGRATIONS, INC.	
Dated: February 24, 2011	By:	/s/ SANDEEP NAYYAR **Sandeep Nayyar** **Chief Financial Officer**

87

Table of Contents

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Balu Balakrishnan and Sandeep Nayyar his true and lawful attorney-in-fact and agent, with full power of substitution and, for him and in his name, place and stead, in any and all capacities to sign any and all amendments to this Report on Form 10-K, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES AND ON THE DATES INDICATED.

Dated: February 24, 2011	By:	/s/ BALU BALAKRISHNAN **Balu Balakrishnan** **President, Chief Executive Officer** **(Principal Executive Officer)**
Dated: February 24, 2011	By:	/s/ SANDEEP NAYYAR **Sandeep Nayyar** **Chief Financial Officer** **(Principal Financial and Principal** **Accounting Officer)**
Dated: February 24, 2011	By:	/s/ ALAN D. BICKELL **Alan D. Bickell** **Director**
Dated: February 24, 2011	By:	/s/ NICHOLAS E. BRATHWAITE **Nicholas E. Brathwaite** **Director**
Dated: February 24, 2011	By:	/s/ E. FLOYD KVAMME **E. Floyd Kvamme** **Director**
Dated: February 24, 2011	By:	/s/ STEVEN J. SHARP **Steven J. Sharp** **Director and Chairman of the Board**
Dated: February 24, 2011	By:	/s/ BALAKRISHNAN S. IYER **Balakrishnan S. Iyer** **Director**
Dated: February 24, 2011	By:	/s/ JAMES FIEBIGER **James Fiebiger** **Director**
Dated: February 24, 2011	By:	/s/ WILLIAM GEORGE **Bill George** **Director**

Table of Contents

POWER INTEGRATIONS, INC.

INDEX TO EXHIBITS

TO

FORM 10-K ANNUAL REPORT

For the Year Ended

December 31, 2010

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	Certificate of Amendment to Certificate of Incorporation (As filed with the SEC as the like described exhibit to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.)
3.5	Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.2 to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.)
4.1	Reference is made to Exhibits 3.1 to 3.5.
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	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, SEC File No. 000-23441).*
10.3	1997 Outside Directors Stock Option Plan (as filed with the SEC as Exhibit 10.3 to our Quarterly Report on Form 10-Q on August 6, 2009, SEC File No. 000-23441) 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).*
10.4	1997 Employee Stock Purchase Plan (as filed with the SEC as Exhibit 10.5 to our Annual Report on Form 10-K on March 2, 2009). The 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).*
10.5	1998 Nonstatutory Stock Option Plan. (As filed with the SEC as Exhibit 10.4 to our Quarterly Report on Form 10-Q on August 6, 2009, SEC File No. 000-23441.)*
10.6	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.)*
10.7	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.)*
10.8	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.)*

Table of Contents

EXHIBIT NUMBER	DESCRIPTION
10.9	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.)*
10.10	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.)
10.11	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.)
10.12	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.)
10.13	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.)
10.14	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.)
10.15	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.)
10.16	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.)
10.17	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.)
10.18	2009 Executive Officer Cash Compensation Arrangements and 2009 Bonus Plan (As described in Item 5.02 of our Current Report on Form 8-K filed with the SEC on March 13, 2009, SEC File No. 000-23441.)*
10.19	Form of Director Option Grant Agreement. (As filed with the SEC as Exhibit 10.9 to our Quarterly Report on Form 10-Q on May 6, 2009, SEC File No. 000-23441.)*
10.20	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 Exhibit 10.35 to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.21	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 Exhibit 10.36 to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.22	Amendment Number One to the Wafer Supply Agreement between Power Integrations International, Ltd. and Seiko Epson Corporation, with an effective date of December 19, 2008. (As filed with the SEC as Exhibit 10.1 to our Quarterly Report on Form 10-Q on May 6, 2009, SEC File No. 000-23441.)
10.23	2007 Equity Incentive Plan, and amendment and restatement of the 1997 Stock Option Plan (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q on August 6, 2009, SEC File No. 000-23441.)*

Table of Contents

EXHIBIT NUMBER	DESCRIPTION
10.24	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. (As filed with the SEC as Exhibit 10.40 to our Annual Report on Form 10-K on August 8, 2007, SEC File No. 000-23441.)*
10.25	Forms of Option Agreements under the 1997 Stock Option Plan. (As filed with the SEC as Exhibit 10.41 to our Annual Report on Form 10-K on August 8, 2007, SEC File No. 000-23441.)*
10.26	Letter agreement, dated as of August 31, 2007, between Power Integrations, Inc. and Derek Bell. (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.27	Amended and Restated Chief Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Balu Balakrishnan. (As filed with the SEC as Exhibit 10.3 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.28	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Bruce Renouard. (As filed with the SEC as Exhibit 10.4 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.29	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Cliff Walker. (As filed with the SEC as Exhibit 10.6 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.30	Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Doug Bailey. (As filed with the SEC as Exhibit 10.8 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.31	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Derek Bell. (As filed with the SEC as Exhibit 10.9 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
10.32	Amendment Number Two to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and OKI Electric Industry Co., Ltd., effective as of April 1, 2008. (As filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q filed on August 8, 2008, SEC File No. 000-23441.)
10.33	Amendment Number Three to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and OKI Electric Industry Co., Ltd., effective as of June 9, 2008. (As filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q filed on August 8, 2008, SEC File No. 000-23441.)
10.34	Form of Performance Stock Unit Grant Notice and Performance Stock Unit Agreement. (As filed with the SEC as Exhibit 10.1 to our Quarterly Report on Form 10-Q on August 6, 2009, SEC File No. 000-23441.)*

Table of Contents

EXHIBIT NUMBER	DESCRIPTION
10.35	Forms of Option Agreements under the 2007 Equity Incentive Plan (As filed with the SEC as Exhibit 99.(d)(4) to our Schedule TO filed on December 3, 2008, SEC File No. 000-23441.)*
10.36	Wafer Supply Agreement, between Seiko Epson Corporation and Power Integrations International, Ltd. effective as of April 1, 2005. (As filed with the SEC as Exhibit 10.1 to our Quarterly Report on Form 10-Q filed on November 7, 2008, SEC File No. 000-23441.)
10.37	Amendment Number Four to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and OKI Electric Industry Co., Ltd., dated September 15, 2008. (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q filed on November 7, 2008, SEC File No. 000-23441.)
10.38	Forms of Stock Option Agreements to be used in Director Equity Compensation Program. (As filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q filed on November 7, 2008, SEC File No. 000-23441.)
10.39	Amendment to Immediately Exercisable Non-Qualified Stock Option Agreement between Power Integrations, Inc. and Balu Balakrishnan, dated February 2, 2009 (as filed with the SEC as Exhibit 10.59 to our Annual Report on Form 10-K on March 2, 2009, SEC File No. 000-23441.).*
10.40	Director Equity Compensation Program, as revised January 27, 2009 (as filed with the SEC as Exhibit 10.60 to our Annual Report on Form 10-K on March 2, 2009, SEC File No. 000-23441.).*
10.41	Amendment Number Five to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and OKI Semiconductor Co., Ltd., dated November 14, 2008 (as filed with the SEC as Exhibit 10.61 to our Annual Report on Form 10-K on March 2, 2009, SEC File No. 000-23441.).
10.42	Amendment No. 1 to the Power Integrations, Inc. 1997 Outside Directors Stock Option Plan, effective as of January 27, 2009 (as filed with the SEC as Exhibit 10.62 to our Annual Report on Form 10-K on March 2, 2009, SEC File No. 000-23441.).*
10.43	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 Exhibit 10.37 to our Annual Report on Form 10-K on March 8, 2007, SEC File No. 000-23441.)*
10.44	Power Integrations, Inc. Compliance Policy Regarding IRC Section 409A (as filed with the SEC as Exhibit 10.63 to our Annual Report on Form 10-K on March 2, 2009, SEC File No. 000-23441.).*
10.45	Amendment Number Five to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and XFAB Dresden GmbH & Co. KG, dated December 23, 2009 . (As filed with the SEC as Exhibit 10.65 to our Annual Report on Form 10-K on February 26, 2010, SEC File No. 000-23441.)
10.46	Amendment Number One to the Amended and Restated Wafer Supply Agreement between Power Integrations International, Ltd. and XFAB Dresden GmbH & Co. KG, effective as of July 20, 2005 . (As filed with the SEC as Exhibit 10.66 to our Annual Report on Form 10-K on February 26, 2010, SEC File No. 000-23441.)
10.47	Amendment No. 2 to Wafer Supply Agreement, between Seiko Epson Corporation and Power Integrations International, Ltd., entered into on January 5, 2011
10.48	Form of Restricted Stock Unit Grant Notice and Form of Restricted Stock Unit Award Agreement (As filed with the SEC as Exhibit 10.1 to our Quarterly Report on Form 10-Q on May 6, 2010, SEC File No. 000-23441.).*
10.49	Amendment No. 2 to the Power Integrations, Inc. 1997 Outside Directors Stock Option Plan, effective as of April 12, 2010 (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q filed on May 6, 2010, SEC File No. 000-23441.)*

Table of Contents

EXHIBIT NUMBER	DESCRIPTION
10.50	2010 Executive Compensation Arrangements (Described under Item 5.02 of our Current Reports on Form 8-K, as filed with the SEC on February 5, 2010 and April 16, 2010, SEC File No. 000-23441.)*
10.51	Severance Agreement, dated May 21, 2010, between Power Integrations, Inc. and Bill Roeschlein (As filed with the SEC as Exhibit 10.1 to our Quarterly Report on Form 10-Q on August 6, 2010, SEC File No. 000-23441.).*
10.52	Offer Letter, dated June 23, 2010, between Power Integrations, Inc. and Sandeep Nayyar (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q on August 6, 2010, SEC File No. 000-23441.).*
10.53	Executive Officer Benefits Agreement, dated July 22, 2010, between Power Integrations, Inc. and Sandeep Nayyar (As filed with the SEC as Exhibit 10.3 to our Quarterly Report on Form 10-Q on August 6, 2010, SEC File No. 000-23441.).*
10.54	Amendment No. 2 to the Power Integrations, Inc. 1997 Outside Directors Stock Option Plan, effective as of April 12, 2010. (As filed with the SEC as Exhibit 10.2 to our Quarterly Report on Form 10-Q on May 6, 2010, SEC File No. 000-23441.)*
10.55	Form of Restricted Stock Unit Grant Notice and Form of Restricted Stock Unit Award Agreement for executive officers (As filed with the SEC as Exhibit 10.6 to our Quarterly Report on Form 10-Q on August 6, 2010, SEC File No. 000-23441.).*
10.56	Outside Director Cash Compensation Arrangements (As filed with the SEC as Exhibit 10.3 to our Quarterly Report on Form 10-Q on November 3, 2010, SEC File No. 000-23441.).*
10.57	Amendment to Executive Officer Benefits Agreement between Power Integrations, Inc. and Sandeep Nayyar, dated October 29, 2010.*
10.58	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and John Tomlin. (As filed with the SEC as Exhibit 10.5 to our Quarterly Report on Form 10-Q on November 9, 2007, SEC File No. 000-23441.)*
14.1	Code of Business Conduct and Ethics (As filed with the SEC as the like described exhibit to our Current Report on Form 8-K on February 4, 2008, SEC File No. 000-23441.)
21.1	List of subsidiaries.
23.1	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney (See signature page).
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document

Table of Contents

EXHIBIT NUMBER	DESCRIPTION
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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

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 any filing of Power Integrations, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-K, irrespective of any general incorporation language contained in such filing.