POWER INTEGRATIONS INC
Form 10-Q
July 27, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

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FORM 10-Q

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(Mark One)
x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2017
or
o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ______ to ______
Commission File Number 000-23441

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POWER INTEGRATIONS, INC.
(Exact name of registrant as specified in its charter)

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

5245 Hellyer Avenue, San Jose, California, 95138
(Address of principal executive offices) (Zip code)
(408) 414-9200
(Registrant's telephone number, including area code)

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

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

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

| | |
|---|---|
| Large accelerated filer x | Accelerated filer o |
| Non-accelerated filer o | Smaller reporting company o |
| (Do not check if a smaller reporting company) | Emerging growth company o |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

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

| Class | Shares Outstanding at July 14, 2017 |
|---|---|
| Common Stock, $0.001 par value | 29,758,991 |

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words “would,” “could,” “will,” “may,” “expect,” “believe,” “should,” “anticipate,” “if,” “future,” “intend,” “plan,” “estimate,” “potential,” “target,” “seek” or “continue” and si phrases, including the negatives of these terms, or other variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under the caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016, and in Item 2 of Part I — “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this Quarterly Report on Form 10-Q, including, but not limited to: our quarterly operating results are volatile and difficult to predict, and if we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly; if demand for our products declines in our major end markets, our net revenues will decrease; intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products; if we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability; if we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies; and our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we expressly disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information or otherwise, except as required by laws.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

| (In thousands) | June 30, 2017 | December 31, 2016 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $32,649 | $ 62,134 |
| Short-term marketable securities | 221,346 | 188,323 |
| Accounts receivable, net of allowances for doubtful accounts of $605 and $525 in 2017 and 2016, respectively | 18,697 | 6,528 |
| Inventories | 52,432 | 52,564 |
| Prepaid expenses and other current assets | 16,902 | 8,715 |
| Total current assets | 342,026 | 318,264 |
| PROPERTY AND EQUIPMENT, net | 113,202 | 95,296 |
| INTANGIBLE ASSETS, net | 28,324 | 31,502 |
| GOODWILL | 91,849 | 91,849 |
| DEFERRED TAX ASSETS | 19,328 | 11,342 |
| OTHER ASSETS | 6,809 | 6,157 |
| Total assets | $601,538 | $ 554,410 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | $30,124 | $ 29,727 |
| Accrued payroll and related expenses | 11,639 | 10,756 |
| Taxes payable | 1,072 | 729 |
| Other accrued liabilities | 3,858 | 2,734 |
| Total current liabilities | 46,693 | 43,946 |
| LONG-TERM INCOME TAXES PAYABLE | 2,805 | 2,639 |
| DEFERRED TAX LIABILITIES | 615 | 820 |
| OTHER LIABILITIES | 4,422 | 3,921 |
| Total liabilities | 54,535 | 51,326 |
| COMMITMENTS AND CONTINGENCIES (Notes 11, 12 and 13) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock | 29 | 28 |
| Additional paid-in capital | 189,259 | 172,875 |
| Accumulated other comprehensive loss | (2,419) | (2,710) |
| Retained earnings | 360,134 | 332,891 |
| Total stockholders' equity | 547,003 | 503,084 |
| Total liabilities and stockholders' equity | $601,538 | $ 554,410 |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| (In thousands, except per share amounts) | 2017 | 2016 | 2017 | 2016 |
| NET REVENUES | $107,563 | $97,571 | $212,251 | $185,607 |
| COST OF REVENUES | 54,116 | 49,786 | 108,328 | 93,334 |
| GROSS PROFIT | 53,447 | 47,785 | 103,923 | 92,273 |
| | | | | |
| OPERATING EXPENSES: | | | | |
| Research and development | 17,341 | 15,859 | 33,981 | 30,638 |
| Sales and marketing | 13,144 | 12,018 | 25,360 | 23,424 |
| General and administrative | 8,765 | 8,133 | 17,469 | 15,983 |
| Total operating expenses | 39,250 | 36,010 | 76,810 | 70,045 |
| INCOME FROM OPERATIONS | 14,197 | 11,775 | 27,113 | 22,228 |
| OTHER INCOME | 465 | 236 | 971 | 497 |
| INCOME BEFORE INCOME TAXES | 14,662 | 12,011 | 28,084 | 22,725 |
| PROVISION FOR INCOME TAXES | 760 | 604 | 83 | 939 |
| NET INCOME | $13,902 | $11,407 | $28,001 | $21,786 |
| | | | | |
| EARNINGS PER SHARE: | | | | |
| Basic | $0.47 | $0.40 | $0.95 | $0.76 |
| Diluted | $0.46 | $0.39 | $0.92 | $0.74 |
| | | | | |
| SHARES USED IN PER SHARE CALCULATION: | | | | |
| Basic | 29,720 | 28,850 | 29,589 | 28,765 |
| Diluted | 30,454 | 29,422 | 30,370 | 29,361 |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| (In thousands) | 2017 | 2016 | 2017 | 2016 |
| NET INCOME | $13,902 | $11,407 | $28,001 | $21,786 |
| Other comprehensive income, net of tax: | | | | |
| Foreign currency translation adjustments, net of $0 tax in the three and six months ended June 30, 2017 and 2016 | 31 | 37 | 95 | (17 ) |
| Unrealized gain on marketable securities, net of $0 tax in the three and six months ended June 30, 2017 and 2016 | 15 | 48 | 98 | 261 |
| Amortization of defined benefit pension items, net of tax of $14 and $27 in the three and six months ended June 30, 2017, respectively, and $11 and $22 in the three and six months ended June 30, 2016, respectively | 49 | 40 | 98 | 80 |
| Total other comprehensive income | 95 | 125 | 291 | 324 |
| TOTAL COMPREHENSIVE INCOME | $13,997 | $11,532 | $28,292 | $22,110 |

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

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

| | Six Months Ended June 30, | |
|---|---|---|
| (In thousands) | 2017 | 2016 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $28,001 | $21,786 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 8,469 | 8,521 |
| Amortization of intangibles | 3,178 | 3,439 |
| Loss on disposal of property and equipment | 38 | 148 |
| Stock-based compensation expense | 11,296 | 9,428 |
| Amortization of premium on marketable securities | 508 | 429 |
| Deferred income taxes | (648 ) | 225 |
| Increase in accounts receivable allowances | 80 | 193 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | (12,249 ) | (6,252 ) |
| Inventories | 132 | 5,185 |
| Prepaid expenses and other assets | (8,349 ) | (674 ) |
| Accounts payable | (3,629 ) | 3,039 |
| Taxes payable and accrued liabilities | 3,208 | (1,566 ) |
| Net cash provided by operating activities | 30,035 | 43,901 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (22,876 ) | (4,890 ) |
| Purchases of marketable securities | (111,574) | (66,211 ) |
| Proceeds from maturities of marketable securities | 78,140 | 52,921 |
| Net cash used in investing activities | (56,310 ) | (18,180 ) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Issuance of common stock under employee stock plans | 5,089 | 3,448 |
| Repurchase of common stock | — | (6,435 ) |
| Payments of dividends to stockholders | (8,299 ) | (7,483 ) |
| Net cash used in financing activities | (3,210 ) | (10,470 ) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (29,485 ) | 15,251 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 62,134 | 90,092 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $32,649 | $105,343 |
| | | |
| SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Unpaid property and equipment | $5,851 | $1,140 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid (refund) for income taxes, net | $(1,775 ) | $4,564 |

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

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:
The condensed consolidated financial statements include the accounts of Power Integrations, Inc., a Delaware corporation (the "Company"), and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.
While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and the notes thereto for the year ended December 31, 2016, included in its Form 10-K filed on February 8, 2017, with the Securities and Exchange Commission.

2. SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS:
Significant Accounting Policies and Estimates
Except for the changes below, no material changes have been made to the Company's significant accounting policies disclosed in Note 2, Summary of Significant Accounting Policies, in its Annual Report on Form 10-K, filed on February 8, 2017, for the year ended December 31, 2016. The accounting policy information below is to aid in the understanding of the financial information disclosed.
The Company adopted Accounting Standards Codification 606, Revenue from Contracts with Customers (ASC 606-10), effective on January 1, 2017. Prior to the adoption of ASC 606-10, the Company deferred the recognition of revenue and the cost of revenue from certain sales until the distributors reported that they had sold the products to their customers (known as "sell-through" revenue recognition). Under ASC 606-10, the Company recognizes revenue on sales to all distributors upon shipment and transfer of control (known as "sell-in" revenue recognition). As a result of this adoption, the Company revised its accounting policy for revenue recognition as detailed below.
Revenue Recognition
The Company applies the provisions of Accounting Standards Codification (ASC) 606-10, Revenue from Contracts with Customers, and all related appropriate guidance. The Company recognizes revenue under the core principle to depict the transfer of control to the Company's customers in an amount reflecting the consideration the Company expects to be entitled. In order to achieve that core principle, the Company applies the following five step approach: (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when a performance obligation is satisfied.
Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. The Company considers customer purchase orders, which in some cases are governed by master sales agreements, to be the contracts with a customer. In situations where sales are to a distributor, the Company has concluded that its contracts are with the distributor as the Company holds a contract bearing enforceable rights and obligations only with the distributor. As part of its consideration of the contract, the Company evaluates certain factors including the customer's ability to pay (or credit risk). For each contract, the Company considers the promise to transfer products, each of which is distinct, to be the identified performance obligations. In determining the transaction price the Company evaluates whether the price is subject to refund or adjustment to determine the net consideration to which the Company expects to be entitled. As the Company's standard payment terms are less than one year, the Company has elected the practical expedient under ASC 606-10-32-18 to not assess whether a contract has a significant financing component. The Company allocates the transaction price to each distinct product based on their relative standalone selling price. The product price as specified on the purchase order is considered the standalone selling price as it is an observable input which depicts the price as if sold to a similar customer in similar

circumstances. Revenue is recognized when control of the product is transferred to the customer (i.e., when the Company's performance obligation is satisfied), which typically occurs at shipment. Further, in determining whether control has transferred, the Company considers if there is a present right to payment and legal title, along with risks and rewards of ownership having transferred to the customer.

Frequently, the Company receives orders for products to be delivered over multiple dates that may extend across several reporting periods. The Company invoices for each delivery upon shipment and recognizes revenues for each distinct product delivered, assuming transfer of control has occurred. As scheduled delivery dates are within one year, under the optional exemption provided by ASC 606-10-50-14 revenues allocated to future shipments of partially completed contracts are not disclosed.

Sales to international customers that are shipped from the Company's facility outside of the United States are pursuant to EX Works, or EXW, shipping terms, meaning that control of the product transfers to the customer upon shipment from the Company's foreign warehouse. Sales to international customers that are shipped from the Company's facility in California are pursuant to Delivered at Frontier, or DAF, shipping terms. As such, control of 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. Shipments to customers in the Americas are pursuant to Free on Board, or FOB, point of origin shipping terms meaning that control is passed to the customer upon shipment.

Sales to most distributors are made under terms allowing certain price adjustments and limited rights of return (known as "stock rotation") of the Company's products held in their inventory or upon sale to their end customers. Revenue from sales to distributors is recognized upon the transfer of control to the distributor. Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At the time the distributor invoices its customer or soon thereafter, the distributor submits a "ship and debit" price adjustment claim to the Company to adjust the distributor's cost from the standard price to the pre-approved lower price. After the Company verifies that the claim was pre-approved, a credit memo is issued to the distributor for the ship and debit claim. In determining the transaction price, the Company considers ship and debit price adjustments to be variable consideration. Such price adjustments are estimated using the expected value method based on an analysis of actual ship and debit claims, at the distributor and product level, over a period of time considered adequate to account for current pricing and business trends. Historically, actual price adjustments for ship and debit claims relative to those estimated and included when determining the transaction price have not materially differed. Stock rotation rights grant the distributor the ability to return certain specified amounts of inventory. Stock rotation adjustments are an additional form of variable consideration and are also estimated using the expected value method based on historical return rates. Historically, distributor stock rotation adjustments have not been material.

Sales to certain distributors are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, upon application of steps one through five above, product revenue is recognized upon shipment and transfer of control.

The Company generally provides an assurance warranty that its products will substantially conform to the published specifications for twelve 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. As such, the Company does not record a specific warranty reserve or consider activities related to such warranty, if any, to be a separate performance obligation.

Adoption of New Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, amending the existing accounting standards for revenue recognition. The Company elected to early adopt these standards, effective on January 1, 2017, using the full retrospective method, under which the amendments were applied to all prior periods presented. Under the new standards the Company recognizes all revenue on sales to distributors upon shipment and transfer of control (known as "sell-in" revenue recognition), rather than deferring recognition on sales to certain distributors until the distributors report that they have sold the products to their customers (known as "sell-through" revenue recognition).

The impact of adoption on the Company's previously reported condensed consolidated financial statements were as follows:

| Condensed Consolidated Balance Sheet: | December 31, 2016 | | |
|---|---|---|---|
| (In thousands) | As Reported | Impact of Adoption | As Adjusted |
| Accounts receivable, net | $6,961 | $(433) | $6,528 |
| Prepaid expenses and other current assets | 8,520 | 195 | 8,715 |
| Deferred tax assets | 12,032 | (690) | 11,342 |
| Deferred income on sales to distributors | 16,207 | (16,207) | — |

| | | | |
|---|---|---|---|
| Other accrued liabilities | 2,434 | 300 | 2,734 |
| Retained earnings | $317,912 | $14,979 | $332,891 |

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

| Condensed Consolidated Statements of Income: | Three Months Ended June 30, 2016 | | | Six Months Ended June 30, 2016 | | |
|---|---|---|---|---|---|---|
| (In thousands, except per share) | As Reported | Impact of Adoption | As Adjusted | As Reported | Impact of Adoption | As Adjusted |
| Net revenues | $97,169 | $ 402 | $ 97,571 | $182,495 | $ 3,112 | $185,607 |
| Cost of revenues | 49,532 | 254 | 49,786 | 91,911 | 1,423 | 93,334 |
| Provision for income taxes | 598 | 6 | 604 | 928 | 11 | 939 |
| Net income | $11,265 | $ 142 | $ 11,407 | $20,108 | $ 1,678 | $21,786 |
| | | | | | | |
| Earnings per share | | | | | | |
| Basic | $0.39 | $ 0.01 | $ 0.40 | $0.70 | $ 0.06 | $0.76 |
| Diluted | $0.38 | $ 0.01 | $ 0.39 | $0.68 | $ 0.06 | $0.74 |

| Condensed Consolidated Statement of Cash Flows: | Six Months Ended June 30, 2016 | | |
|---|---|---|---|
| (In thousands) | As Reported | Impact of Adoption | As Adjusted |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | $20,108 | $ 1,678 | $21,786 |
| Deferred income taxes | 214 | 11 | 225 |
| Accounts receivable | (6,385 ) | 133 | (6,252 ) |
| Prepaid expenses and other assets | (639 ) | (35 ) | (674 ) |
| Deferred income on sales to distributors | $1,787 | $ (1,787 ) | $— |

In March 2016, the FASB amended the existing accounting standards for stock-based compensation, ASU 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09). The amendments impact several aspects of accounting for share-based payment transactions, including the income tax consequences, forfeitures, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The manner of application varies by the various provisions of the guidance, with certain provisions applied on a retrospective or modified retrospective approach, while others are applied prospectively. The Company adopted the new standards in the first quarter of 2017, effective on January 1, 2017. Upon adoption, the Company recognized a windfall tax benefit of $7.5 million, as a cumulative effect adjustment to opening retained earnings, together with a corresponding increase in deferred tax assets.

Recent Accounting Pronouncements

In February 2016, the FASB amended the existing accounting standards for leases, ASU 2016-02, Leases. The amendments require lessees to recognize, on the balance sheet, assets and liabilities for the rights and obligations created by leases of greater than twelve months. The accounting by lessors will remain largely unchanged from that applied under previous U.S. GAAP. The Company is required to adopt the amendments in the first quarter of fiscal 2019, with early adoption permitted. The amendments require a modified retrospective transition approach to recognize and measure leases at the beginning of the earliest period presented. The Company is currently evaluating the impact of these amendments on its condensed consolidated financial statements.

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

Accounts Receivable

| (In thousands) | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Accounts receivable trade | $64,621 | $ 46,849 |
| Allowances for ship and debit | (44,218 ) | (38,075 ) |
| Allowances for stock rotation and rebate | (1,101 ) | (1,721 ) |

| | | |
|---|---|---|
| Allowances for doubtful accounts | (605 ) | (525 ) |
| Total | $18,697 | $ 6,528 |

Inventories

| (In thousands) | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Raw materials | $12,215 | $ 14,610 |
| Work-in-process | 16,442 | 15,194 |
| Finished goods | 23,775 | 22,760 |
| Total | $52,432 | $ 52,564 |

Prepaid Expenses and Other Current Assets

| (In thousands) | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Prepaid legal fees | $3,698 | $ 212 |
| Prepaid income tax | 464 | 2,431 |
| Prepaid maintenance agreements | 1,443 | 1,399 |
| Interest receivable | 1,200 | 743 |
| Advance to suppliers | 6,072 | 69 |
| Other | 4,025 | 3,861 |
| Total | $16,902 | $ 8,715 |

Intangible Assets

| | June 30, 2017 | | | December 31, 2016 | | |
|---|---|---|---|---|---|---|
| (In thousands) | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| Domain name | $1,261 | $ — | $1,261 | $1,261 | $ — | $1,261 |
| In-process research and development | 4,690 | — | 4,690 | 4,690 | — | 4,690 |
| Developed technology | 33,270 | (17,333 ) | 15,937 | 33,270 | (15,455 ) | 17,815 |
| Customer relationships | 20,030 | (13,594 ) | 6,436 | 20,030 | (12,474 ) | 7,556 |
| In-place leases | 660 | (660 ) | — | 660 | (480 ) | 180 |
| Total intangible assets | $59,911 | $ (31,587 ) | $28,324 | $59,911 | $ (28,409 ) | $31,502 |

The estimated future amortization expense related to finite-lived intangible assets at June 30, 2017, is as follows:

| Fiscal Year | Estimated Amortization (in thousands) |
|---|---|
| 2017 (remaining 6 months) | $ 2,906 |
| 2018 | 5,152 |
| 2019 | 4,753 |
| 2020 | 3,528 |
| 2021 | 2,662 |
| Thereafter | 3,372 |
| Total [(1)] | $ 22,373 |

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

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss for the three and six months ended June 30, 2017 and 2016, were as follows:

| | Unrealized Gains and Losses on Marketable | Defined Benefit Pension Items | Foreign Currency Items | Total |
|---|---|---|---|---|

| (In thousands) | Securities Three Months Ended June 30, 2017 | 2016 | Three Months Ended June 30, 2017 | 2016 | Three Months Ended June 30, 2017 | 2016 | Three Months Ended June 30, 2017 | 2016 |
|---|---|---|---|---|---|---|---|---|
| Beginning balance | $(137) | $116 | $(1,887) | $(1,544) | $(490) | $(224) | $(2,514) | $(1,652) |
| Other comprehensive income (loss) before reclassifications | 15 | 48 | — | — | 31 | 37 | 46 | 85 |
| Amounts reclassified from accumulated other comprehensive income (loss) | — | — | 49 (1) | 40 (1) | — | — | 49 | 40 |
| Net-current period other comprehensive income (loss) | 15 | 48 | 49 | 40 | 31 | 37 | 95 | 125 |
| Ending balance | $(122) | $164 | $(1,838) | $(1,504) | $(459) | $(187) | $(2,419) | $(1,527) |

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the three months ended June 30, 2017 and 2016.

| | Unrealized Gains and Losses on Marketable Securities | | Defined Benefit Pension Items | | Foreign Currency Items | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Six Months Ended June 30, | | Six Months Ended June 30, | | Six Months Ended June 30, | | Six Months Ended June 30, | |
| (In thousands) | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Beginning balance | $(220) | $(97) | $(1,936) | $(1,584) | $(554) | $(170) | $(2,710) | $(1,851) |
| Other comprehensive income (loss) before reclassifications | 98 | 261 | — | — | 95 | (17) | 193 | 244 |
| Amounts reclassified from accumulated other comprehensive income (loss) | — | — | 98 (1) | 80 (1) | — | — | 98 | 80 |
| Net-current period other comprehensive income (loss) | 98 | 261 | 98 | 80 | 95 | (17) | 291 | 324 |
| Ending balance | $(122) | $164 | $(1,838) | $(1,504) | $(459) | $(187) | $(2,419) | $(1,527) |

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the six months ended June 30, 2017 and 2016.

4. FAIR VALUE MEASUREMENTS:

The FASB established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices for identical assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's cash equivalents and short-term marketable securities are classified within Level 1 or Level 2 of the fair-value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

The fair-value hierarchy of the Company's cash equivalents and marketable securities at June 30, 2017, and December 31, 2016, was as follows:

| | Fair Value Measurement at June 30, 2017 | | |
|---|---|---|---|
| (In thousands) | Total Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Corporate securities | $193,901 | $ — | $ 193,901 |
| Commercial paper | 23,654 | — | 23,654 |
| Government securities | 9,366 | — | 9,366 |
| Money market funds | 133 | 133 | — |
| Total | $227,054 | $ 133 | $ 226,921 |

| | Fair Value Measurement at December 31, 2016 | | |
|---|---|---|---|
| (In thousands) | Total Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Corporate securities | $132,141 | $ — | $ 132,141 |
| Commercial paper | 58,031 | — | 58,031 |
| Money market funds | 1,916 | 1,916 | — |
| Total | $192,088 | $ 1,916 | $ 190,172 |

The Company did not transfer any investments between Level 1 and Level 2 of the fair-value hierarchy in the six months ended June 30, 2017, and the twelve months ended December 31, 2016.

## 5. MARKETABLE SECURITIES:

Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at June 30, 2017, were as follows:

| (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Market Value |
|---|---|---|---|---|
| Investments due in 3 months or less: | | | | |

| | | | | |
|---|---|---|---|---|
| Commercial paper | $ 18,079 | $— | $— | $ 18,079 |
| Corporate securities | 24,463 | — | (5 ) | 24,458 |
| Total | 42,542 | — | (5 ) | 42,537 |
| Investments due in 4-12 months: | | | | |
| Corporate securities | 110,313 | 10 | (88 ) | 110,235 |
| Total | 110,313 | 10 | (88 ) | 110,235 |
| Investments due in 12 months or greater: | | | | |
| Corporate securities | 59,241 | 19 | (52 ) | 59,208 |
| Government securities | 9,372 | — | (6 ) | 9,366 |
| Total | 68,613 | 19 | (58 ) | 68,574 |
| Total marketable securities | $ 221,468 | $29 | $(151) | $ 221,346 |

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Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at December 31, 2016, were as follows:

| (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Market Value |
|---|---|---|---|---|
| Investments due in 3 months or less: | | | | |
| Commercial paper | $36,996 | $— | $— | $36,996 |
| Corporate securities | 9,342 | 2 | (2) | 9,342 |
| Total | 46,338 | 2 | (2) | 46,338 |
| Investments due in 4-12 months: | | | | |
| Commercial paper | 19,186 | — | — | 19,186 |
| Corporate securities | 59,714 | 15 | (76) | 59,653 |
| Total | 78,900 | 15 | (76) | 78,839 |
| Investments due in 12 months or greater: | | | | |
| Corporate securities | 63,305 | 21 | (180) | 63,146 |
| Total | 63,305 | 21 | (180) | 63,146 |
| Total marketable securities | $188,543 | $38 | $(258) | $188,323 |

As of June 30, 2017, and December 31, 2016, the Company evaluated the nature of the investments with a loss position, which were primarily high-quality corporate and government securities, and determined the unrealized losses were not other-than-temporary.

6. STOCK-BASED COMPENSATION:

The following table summarizes the stock-based compensation expense for the three and six months ended June 30, 2017, and June 30, 2016:

| (In thousands) | Three Months Ended June 30, 2017 | Three Months Ended June 30, 2016 | Six Months Ended June 30, 2017 | Six Months Ended June 30, 2016 |
|---|---|---|---|---|
| Cost of revenues | $351 | $293 | $494 | $383 |
| Research and development | 2,351 | 1,940 | 3,985 | 3,409 |
| Sales and marketing | 1,189 | 899 | 2,286 | 1,926 |
| General and administrative | 2,436 | 1,880 | 4,531 | 3,710 |
| Total stock-based compensation expense | $6,327 | $5,012 | $11,296 | $9,428 |

Stock-based compensation expense in the three months ended June 30, 2017 was $6.3 million (comprising approximately $2.3 million related to performance-based (PSU) awards and long-term performance-based (PRSU) awards, $3.7 million related to restricted stock unit (RSU) awards and $0.3 million related to the Company’s employee stock purchase plan). In the six months ended June 30, 2017, stock-based compensation expense was $11.3 million (comprising approximately $3.5 million related to PSUs and PRSUs, $7.2 million related to RSUs and $0.6 million related to the Company’s employee stock purchase plan).

Stock-based compensation expense in the three months ended June 30, 2016 was $5.0 million (comprising approximately $0.1 million related to stock options, $1.6 million related to PSUs and PRSUs, $3.0 million related to RSUs and $0.3 million related to the Company’s employee stock purchase plan). In the six months ended June 30, 2016, stock-based compensation expense was $9.4 million (comprising approximately $0.2 million related to stock options, $2.3 million related to PSUs and PRSUs, $6.3 million related to RSUs and $0.6 million related to the Company’s employee stock purchase plan).

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Stock Options
A summary of stock options outstanding as of June 30, 2017, and activity during the six months then ended, is presented below:

| | Shares (in thousands) | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2017 | 697 | $ 28.62 | | |
| Granted | — | — | | |
| Exercised | (84) | $ 31.52 | | |
| Forfeited or expired | — | — | | |
| Outstanding at June 30, 2017 | 613 | $ 28.22 | 2.34 | $ 27,417 |
| Vested and exercisable at June 30, 2017 | 613 | | 2.34 | $ 27,417 |

PSU Awards
Under the performance-based awards program, the Company grants awards in the performance year in an amount equal to twice the target number of shares to be issued if the maximum performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the target number depending on the Company’s performance. The performance metrics of this program are annual targets consisting of a combination of net revenue, non-GAAP operating income and strategic goals.
As the net revenue, non-GAAP operating income and strategic goals are considered performance conditions, expense associated with these awards, net of estimated forfeitures, is recognized over the service period based on an assessment of the achievement of the performance targets. The fair value of these PSUs is determined using the fair value of the Company’s common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.
In January 2017, it was determined that approximately 99,000 shares of the PSUs granted in 2016, vested in aggregate and were released to the Company’s employees and executives in the first quarter of 2017.
A summary of PSUs outstanding as of June 30, 2017, and activity during the six months then ended, is presented below:

| | Shares (in thousands) | Weighted-Average Grant Date Fair Value Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2017 | 99 | $ 46.25 | | |
| Granted | 88 | $ 63.99 | | |
| Vested | (99) | $ 46.25 | | |
| Forfeited | — | — | | |
| Outstanding at June 30, 2017 | 88 | $ 63.99 | 0.50 | $ 6,382 |
| Outstanding and expected to vest at June 30, 2017 | 80 | | 0.50 | $ 5,807 |

PRSU Awards
The Company's PRSU program provides for the issuance of PRSUs which will vest based on the Company's performance measured against the PRSU program's established revenue targets. PRSUs are granted in an amount equal to twice the target number of shares to be issued if the maximum performance metrics are met. The actual number of shares the recipient receives is determined at the end of a three-year performance period based on results achieved versus the Company's performance goals, and may range from zero to 200% of the target number. The performance goals for PRSUs granted in fiscal 2015, 2016 and 2017 were based on the Company’s annual revenue

growth over the respective three-year performance period.

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

A summary of PRSUs outstanding as of June 30, 2017, and activity during the six months then ended, is presented below:

| | Shares (in thousands) | Weighted-Average Grant Date Fair Value Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2017 | 150 | $ 47.65 | | |
| Granted | 71 | $ 63.00 | | |
| Vested | — | — | | |
| Forfeited | (7) | $ 47.89 | | |
| Outstanding at June 30, 2017 | 214 | $ 52.75 | 1.50 | $ 15,615 |
| Outstanding and expected to vest at June 30, 2017 | 186 | | 1.69 | $ 13,543 |

RSU Awards

A summary of RSUs outstanding as of June 30, 2017, and activity during the six months then ended, is presented below:

| | Shares (in thousands) | Weighted-Average Grant Date Fair Value Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2017 | 718 | $ 47.54 | | |
| Granted | 541 | $ 60.46 | | |
| Vested | (266) | $ 46.16 | | |
| Forfeited | (29) | $ 49.02 | | |
| Outstanding at June 30, 2017 | 964 | $ 55.12 | 2.44 | $ 70,284 |
| Outstanding and expected to vest at June 30, 2017 | 854 | | 2.26 | $ 62,277 |

## 7. SIGNIFICANT CUSTOMERS AND GEOGRAPHIC NET REVENUES:

### Segment Reporting

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

### Customer Concentration

The Company's top ten customers accounted for approximately 57% of net revenues in each of the three and six months ended June 30, 2017, and approximately 62% of net revenues in each of the respective corresponding periods of 2016. A significant portion of these revenues are attributable to sales of the Company's products to distributors of electronic components. These distributors sell the Company's products to a broad, diverse range of end users, including original equipment manufacturers (OEMs) and merchant power supply manufacturers. Sales to distributors for the three and six months ended June 30, 2017 were $85.5 million and $166.1 million, respectively, and $73.0 million and $140.3 million, respectively, for the corresponding periods of 2016. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In the three and six months ended June 30, 2017, one customer, a distributor of the Company's products, accounted for more than 10% of the Company's net revenues. In the three and six months ended June 30, 2016, two customers, also distributors, accounted for more than 10% of the Company’s net revenues.

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

| Customer | Three Months Ended June 30, 2017 | 2016 | Six Months Ended June 30, 2017 | 2016 |
|---|---|---|---|---|
| Avnet | 16% | 19% | 17% | 21% |
| Powertech Distribution Ltd. | * | 12% | * | 12% |

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

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

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company does not have any off-balance-sheet credit exposure related to its customers. As of June 30, 2017, and December 31, 2016, 69% and 70%, respectively, of accounts receivable were concentrated with the Company's top 10 customers.

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

| Customer | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Avnet | 20 % | 25 % |
| ATM Electronic Corporation | * | 13 % |

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

Geographic Net Revenues

The Company markets its products globally through its sales personnel and a worldwide network of independent sales representatives and distributors. Geographic net revenues, based on "bill to" customer locations, for the three and six months ended June 30, 2017, and June 30, 2016, were as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (In thousands) | 2017 | 2016 | 2017 | 2016 |
| United States of America | $4,474 | $3,611 | $8,303 | $7,219 |
| Hong Kong/China | 56,547 | 49,355 | 111,392 | 92,697 |
| Taiwan | 10,762 | 14,021 | 23,796 | 24,420 |
| Korea | 9,678 | 9,887 | 19,184 | 19,560 |
| Western Europe (excluding Germany) | 12,751 | 9,839 | 24,722 | 20,550 |
| Japan | 5,837 | 5,535 | 10,485 | 10,343 |
| Germany | 2,915 | 1,751 | 5,711 | 3,850 |
| Other | 4,599 | 3,572 | 8,658 | 6,968 |
| Total net revenues | $107,563 | $97,571 | $212,251 | $185,607 |

8. COMMON STOCK REPURCHASES AND CASH DIVIDENDS:

Common Stock Repurchases

The Company did not repurchase any shares of its common stock in the six months ended June 30, 2017. As of June 30, 2017, the Company had approximately $23.6 million remaining under its repurchase program, which has no expiration date. In July 2017, the Company's board of directors authorized the use of an additional $30.0 million for the repurchase of the Company's common stock, with repurchases to be executed according to pre-defined price/volume guidelines. Authorization of future repurchase programs is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors.

Cash Dividends

In January 2017, the Company's board of directors declared four quarterly cash dividends in the amount of $0.14 per share to be paid to stockholders of record at the end of each quarter in 2017. For the three and six months ended June 30, 2017, and June 30, 2016, cash dividends declared and paid were as follows:

| (In thousands, except per share amounts) | Three Months Ended June 30, 2017 | Three Months Ended June 30, 2016 | Six Months Ended June 30, 2017 | Six Months Ended June 30, 2016 |
|---|---|---|---|---|
| Dividends declared and paid | $4,162 | $3,754 | $8,299 | $7,483 |
| Dividends declared per common share | $0.14 | $0.13 | $0.28 | $0.26 |

## 9. EARNINGS PER SHARE:

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (In thousands, except per share amounts) | 2017 | 2016 | 2017 | 2016 |
| Basic earnings per share: | | | | |
| Net income | $13,902 | $11,407 | $28,001 | $21,786 |
| Weighted-average common shares | 29,720 | 28,850 | 29,589 | 28,765 |
| Basic earnings per share | $0.47 | $0.40 | $0.95 | $0.76 |
| Diluted earnings per share: (1) | | | | |
| Net income | $13,902 | $11,407 | $28,001 | $21,786 |
| Weighted-average common shares | 29,720 | 28,850 | 29,589 | 28,765 |
| Effect of dilutive awards: | | | | |
| Employee stock plans | 734 | 572 | 781 | 596 |
| Diluted weighted-average common shares | 30,454 | 29,422 | 30,370 | 29,361 |
| Diluted earnings per share | $0.46 | $0.39 | $0.92 | $0.74 |

(1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share if the performance conditions have been satisfied as of the end of the reporting period and excludes such shares when the necessary conditions have not been met. The Company has excluded the shares underlying the outstanding performance-based awards in the 2017 and 2016 calculations as the shares were not contingently issuable as of the end of the reporting periods.

In the three and six months ended June 30, 2017 and 2016, no outstanding stock awards were determined to be anti-dilutive and therefore excluded from the computation of diluted earnings per share.

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10. PROVISION FOR INCOME TAXES:
Income-tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur.
The Company's effective tax rates for the three and six months ended June 30, 2017, were 5.2% and 0.3%, respectively. The difference between the statutory rate of 35% and the Company’s effective tax rates for the three and six months ended June 30, 2017, was primarily due to the geographic distribution of the Company’s world-wide earnings in lower tax jurisdictions and federal research tax credits. Additionally, in the three and six months ended June 30, 2017 the rate was favorably impacted by the recognition of excess tax benefits of approximately $0.4 million and $1.4 million, respectively, related to share-based payments. Effective January 1, 2017, the Company adopted ASU 2016-09, under which all excess tax benefits and tax deficiencies are recognized prospectively as income tax expense or benefit in the income statement. For additional details on the adoption of ASU 2016-09, refer to Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in these Notes to Unaudited Condensed Consolidated Financial Statements. The Company's effective tax rates for the three and six months ended June 30, 2016, were 5.0% and 4.1%, respectively. The difference between the expected statutory rate of 35% and the Company's effective tax rates for the three and six months ended June 30, 2016, was due primarily to the geographic distribution of the Company’s world-wide earnings in lower tax jurisdictions and federal research tax credits.
As of June 30, 2017, the Company maintained a valuation allowance on its California deferred tax assets, New Jersey deferred tax assets and capital losses for federal purposes, and a valuation allowance with respect to its deferred tax assets relating to tax credits in Canada.
To ensure an additional source of U.S. cash, the Company plans to repatriate a portion of its current year offshore earnings to the U.S. for domestic operations. The Company has accordingly provided for the estimated federal and state income taxes on such portion of its current year offshore earnings. If circumstances change and it becomes apparent that some or all of the undistributed earnings of the Company’s offshore subsidiary will be remitted in the foreseeable future but income taxes have not been recognized, the Company will accrue income taxes attributable to such undistributed earnings.
Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

11. COMMITMENTS:
Supplier Agreements
Under the terms of the Company's wafer-supply agreements with Seiko Epson Corporation ("Epson"), and ROHM Lapis Semiconductor Co., Ltd. ("Lapis") the wafers purchased from these suppliers are priced in U.S. dollars; however, these agreements also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar on future purchases. Each year, the Company's management and these two suppliers review and negotiate future pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between the Company and each of these suppliers on future purchases.

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

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to pulse width modulation (PWM) integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integrations patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $34.0 million in damages. Fairchild raised defenses contending that the asserted patents are invalid or unenforceable, and the Court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys' fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to $6.1 million, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys' fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent injunction for 90 days. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December 2008. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents, and the Court also invited briefing on enhanced damages and attorneys' fees. Fairchild also filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of $12.9 million. Fairchild filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company filed a cross-appeal seeking to increase the damages award. The appeal was argued on January 11, 2012, and the Federal Circuit issued a mixed ruling on March 26, 2013, affirming Fairchild's infringement of certain claims that support the basis for the permanent injunction while reversing, vacating, and remanding the findings with respect to other claims, including the Company's claim for damages. The Company filed a petition seeking Supreme Court review of the Federal Circuit's ruling on damages issues, and the Supreme Court called for a response from Fairchild but ultimately declined to review the case. On remand, the Company intends to pursue its claim for financial compensation based on Fairchild's infringement.

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

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly owned subsidiary System General Corporation (referred to collectively as "Fairchild"), in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; those products are expected to be addressed in the context of the parties' remand proceedings following the appeal in their earlier litigation in Delaware, and the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On April 18, 2011, the Court rescheduled the trial to begin in January 2012, and on June 2, 2011, the Court moved the trial date to April 2012 to permit the parties to address another patent the Company accused Fairchild of infringing. Following a trial in April 2012, the jury returned a verdict finding that Fairchild infringes two of the Company's patents, that Fairchild has induced others to infringe the Company's patents, and also upheld the validity of the infringed patents. Of the two remaining counterclaim patents Fairchild asserted in the case, one was found not to be infringed, but the jury found the second patent to be infringed by a limited number of the Company's products, although the jury further found the Company did not induce infringement by any customers, including customers outside the United States. On March 29, 2013, the District Court denied most of the parties' post-trial motions on liability but granted the Company's motion for judgment as a matter of law finding that Fairchild infringed another of the Company's patents. On April 25, 2013, the Court denied both parties' motions regarding the unenforceability of each other's patents. The Company challenged adverse findings on appeal; nevertheless, the Company estimated that even if the verdict on Fairchild's patent had ultimately been upheld, the sales potentially impacted would have amounted to less than 0.5% of the Company's revenues. The Company requested an injunction preventing further infringement of its own patents by Fairchild, and Fairchild requested an injunction as well. Following a hearing on the issue in June 2014, the Court denied Fairchild's request for an injunction against the Company and granted the Company's request for an injunction against Fairchild. On January 13, 2015, the District Court entered final judgment on the liability and validity issues discussed above, and both parties filed appeals with the Federal Circuit. After briefing was completed, oral argument on the appeal took place in early July 2016, and on December 12, 2016, the Federal Circuit issued its opinion in the appeal, overturning the lone infringement verdict against the Company, finding one of the Company’s patents invalid, and overturning the District Court’s jury instruction on inducement. In view of the Federal Circuit’s rejection of the District Court’s jury instruction on inducement, the Court also vacated the inducement findings and associated injunction against Fairchild and remanded the case for a retrial on inducement, but the underlying validity and infringement findings against Fairchild on those two patents remain intact. On remand, the Company will also be seeking financial damages in a trial that is scheduled for June of 2018, as well as enhanced damages for Fairchild’s willful infringement.

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 SG and Fairchild from infringing the Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that one of the two of the Company's patents now at issue in the case is unenforceable. On May 5, 2010, SG and Fairchild filed an amended answer including counterclaims accusing the Company of infringing two patents, and since that time Fairchild has withdrawn its claim for infringement of one of the patents it originally asserted against the Company but added another patent to the case over the Company's objections; the Company contests these claims vigorously. Both parties filed summary judgment motions and challenges to each other's experts' testimony, and the Court granted the Company's motion for summary judgment of non-infringement with respect to one of Fairchild's two patents. Following a trial on the remaining claims in February 2014, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of the Company's patents-in-suit, finding that SG and Fairchild infringed the Company's asserted patents and induced infringement by others, and awarding $105.0 million in damages. The Jury also rejected Fairchild's remaining counterclaims for infringement against the Company. Fairchild challenged these rulings in post-trial motions, but the judge confirmed the jury's determinations on infringement and damages, although the Court declined to find Fairchild's infringement willful. Fairchild also pressed its unenforceability claim with respect to one of the two patents it was found to infringe in post-trial briefing, but the Court rejected Fairchild's unenforceability claim. Fairchild also requested reconsideration of the damages determinations, and the Court granted a new trial with respect to damages but none of the other issues addressed in the previous trial, with the retrial scheduled for December 2015. Thereafter, the parties completed pretrial proceedings challenging each other's experts, and the Court granted portions of each party's motions limiting the scope of expert testimony for purposes of the damages retrial, but neither party was successful in their efforts to prevent the other side's experts from testifying at trial. Following a retrial on the issue of damages in December 2015, the jury returned a verdict in the Company's favor, finding that the Company's patented technology created the basis for customer demand for the infringing Fairchild products and awarding $139.8 million in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages verdict. Fairchild filed post-trial motions challenging the verdict, but the Court rejected Fairchild's motions challenging the damages verdict in August 2016. The Company also filed motions requesting enhanced damages and attorney fees and reinstatement of the willfulness finding against Fairchild in view of an intervening change of law; on January 13, 2017, the District Court reinstated the finding that Fairchild's infringement was willful but declined to enhance damages or award fees. In January 2017, Fairchild filed a further challenge to the verdict, but the Court rejected Fairchild's motion and entered a final judgment of $146.5 million after factoring in pre-judgment interest. Fairchild's appeal on the merits is under way, with briefing expected to be completed in the coming months and oral argument and a ruling to follow thereafter.

In February 2010, Fairchild and System General (SG) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The suits asserted four Chinese patents and sought an injunction and damages of approximately $19.0 million. Power Integrations Netherlands filed invalidation proceedings for all four asserted SG patents in the People's Republic of China Patent Reexamination

Board (PRB) of the State Intellectual Property Office (SIPO), and all four challenges were accepted by the PRB, with hearings conducted in September 2010. In early January 2012, the Company received rulings from the PRB invalidating the majority of the claims Fairchild asserted in litigation. The Suzhou Court conducted evidentiary hearings in 2012 and issued rulings in late December 2012, finding that the Company did not infringe any of the asserted patents. Fairchild filed appeals challenging the Suzhou Court’s non-infringement rulings, and the appeals court in Nanjing held further hearings in the infringement proceedings in late 2014, but Fairchild has since dismissed its appeals, bringing the infringement proceedings to a close in the first quarter of 2015.

On July 11, 2011, the Company filed a complaint in the U.S. District Court, District of Columbia, against David Kappos in his capacity as Director of the United States Patent and Trademark Office (PTO) as part of the ongoing reexamination proceedings related to one of the patents asserted against Fairchild and SG in the Delaware litigation described above. The Company filed a motion for summary judgment on a preliminary jurisdictional issue, and the PTO filed a cross-motion to dismiss on this same issue; briefing on those motions was completed in October, 2011. On November 18, 2013, the Court granted the PTO's motion and transferred the case to the Federal Circuit, where additional briefing took place. Following a hearing in May 2015, the Federal Circuit ruled in the Company's favor on August 12, 2015, overturning the PTO's claim construction and remanding the case for further proceedings. On remand, the PTO ignored the Federal Circuit's guidance, so the Company has filed another appeal to the Federal Circuit; briefing on the second appeal is now complete, with oral argument expected in the coming months and a ruling to follow thereafter.

On May 1, 2012, Fairchild Semiconductor Corporation and Fairchild's wholly owned subsidiary, System General Corporation (referred to collectively as "Fairchild"), filed a complaint against the Company in the United States District Court for the District of Delaware. In its complaint, Fairchild alleged that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company answered Fairchild's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid, and the Company also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild withdrew its claim for infringement of one of the patents it asserted against the Company after the Company's preliminary challenge. The parties streamlined their contentions in view of the Court's pretrial rulings, and following a trial in late May and early June 2015, a jury returned a verdict finding that Fairchild infringed one of the Company's patents, that Fairchild has induced and contributed to others' infringement of the Company's patent, and that the Company induced infringement of a Fairchild patent that was previously found infringed in the 2012 trial described above, with a damages award of $2.4 million in favor of Fairchild. Both parties filed post-trial motions and challenges to various portions of the jury verdicts, and the Court addressed the first wave of post-trial motions, denying each side's challenges to the verdict and denying Fairchild's request for an injunction. In parallel proceedings, the Federal Circuit overturned the underlying finding of infringement against the Company on the Fairchild patent-in-suit, and the Company moved to vacate the inducement and damages judgment against the Company, a motion that Fairchild did not oppose. Further proceedings and an appeal of the outstanding issues are expected in the coming months.

On October 21, 2015, the Company filed a complaint for patent infringement against Fairchild Semiconductor Corporation, Fairchild Semiconductor International, Inc., and wholly-owned subsidiary Fairchild (Taiwan) Corporation (referred to collectively as "Fairchild") to address Fairchild's continued infringement of two patents Fairchild was previously found to infringe in the three District Court cases the Company brought against Fairchild discussed above. In each of the three prior cases, Fairchild was found to infringe one of the patents at issue in the latest complaint, and Fairchild's challenges to the validity of the patents were rejected during the course of the prior lawsuits as well. Fairchild has answered the Company's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid. Fairchild's answer also included counterclaims accusing the Company of infringing four patents pertaining to power conversion integrated circuit devices, including one patent the Company was found not to infringe in prior litigation. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. On December 15, 2016, the Court stayed the case pending resolution of the parties' inter partes review (IPR) and reexamination proceedings regarding the patents-in-suit.

On March 10, 2016, Silver Star Capital, LLC filed a petition with the U.S. Patent & Trademark Office (PTO) requesting that the PTO conduct an IPR of the validity of the Company's U.S. Patent No. 6,212,079 (the '079 patent), which the Company has asserted against Fairchild Semiconductor in the California litigation initiated in 2004, as discussed above. The Company's '079 patent is also asserted in the Company's most recent lawsuit against Fairchild filed in October 2015, also discussed above. On March 29, 2016, ON Semiconductor Corporation filed another petition requesting inter partes review of the Company's '079 patent. Since that time, ON Semiconductor filed eleven more IPR petitions requesting review of various patents that the Company previously asserted against Fairchild as described above. The PTO denied Silver Star Capital's IPR petition on the '079 patent but instituted IPR proceedings with respect to ON Semiconductor's petition directed to the '079 patent, with further proceedings expected in the coming months. The PTO also instituted IPR proceedings in response to eight of ON’s eleven other petitions, denying institution in three cases; further proceedings and the Patent Trial and Appeal Board’s initial rulings on the ’079 patent are expected in the coming months. Although the validity of the Company’s challenged patents has previously been confirmed in the Company’s District Court litigation with Fairchild and in many cases in prior PTO reexamination proceedings as well, and though the Company intends to vigorously defend the validity of its patents, the outcome of the IPR proceedings is uncertain.

On April 1, 2016, Opticurrent, LLC filed a complaint against the Company in the United States District Court for the Eastern District of Texas. In its complaint, Opticurrent alleges that the Company has infringed and is infringing one patent pertaining to transistor switch devices. The Company filed a motion to transfer the case to California, which the Court granted, and the case has been assigned to a new judge in San Francisco following the transfer. Further proceedings and expert discovery are expected over the course of the coming months. The Company intends to vigorously defend itself against Opticurrent’s claims.

On August 11, 2016, ON Semiconductor filed a complaint against the Company in the United States District Court for the District of Arizona. In its complaint, ON Semiconductor alleges that the Company has infringed and is infringing six patents and requests injunctive relief, and the complaint also seeks a declaration of non-infringement with respect to three of the Company’s patents that were previously asserted against Fairchild Semiconductor. The Company has not yet answered ON Semiconductor’s complaint, but the Company filed a motion to transfer the case to the Northern District of California, which the Court granted, and the case has been consolidated with the Company’s affirmative case against ON Semiconductor in the Northern District of California, as discussed below. The Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor’s claims.

On November 1, 2016, the Company filed a lawsuit against ON Semiconductor in the United States District Court for the Northern District of California to address ON Semiconductor’s infringement of six patents. The court denied ON Semiconductor’s motion requesting that the case be transferred to Arizona and scheduled trial for December of 2019, with interim deadlines for hearing claim construction and dispositive motions. Further proceedings and discovery will take place over the coming months.

On December 27, 2016, ON Semiconductor filed a complaint against the Company in the United States District Court for the Eastern District of Texas. In its complaint, ON Semiconductor alleges that the Company has infringed and is infringing six patents and requests injunctive relief. On March 9, 2017, ON dismissed its Texas complaint and re-filed a substantially similar complaint in the District of Delaware. The Company filed a motion to dismiss and has not yet answered ON Semiconductor’s complaint, and no date has been set for trial, but the Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor’s claims.

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

13. INDEMNIFICATIONS:

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

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of June 30, 2017. 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.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, and with the consolidated financial statements and management’s discussion and analysis of our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC on February 8, 2017, which reflects our adoption of Accounting Standards Codification 606, Revenue from Contracts with Customers (ASC 606). Refer to Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of this Form 10-Q for further discussion regarding our adoption of ASC 606. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed under the caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016, and in Part II, Item 1A-“Risk Factors” and elsewhere in this report. See also “Cautionary Note Regarding Forward-Looking Statements” at the beginning of this report.

Overview

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

A large percentage of our products are ICs used in AC-DC power supplies, which convert the high-voltage AC from a wall outlet to the low-voltage DC required by most electronic devices. Power supplies incorporating our products are used with all manner of electronic products including mobile phones, computing and networking equipment, appliances, electronic utility meters, power tools, industrial controls, lighting applications that utilize light-emitting diodes (LEDs), and “smart-home,” or “internet of things” applications such as networked thermostats, power strips and other home-automation and security devices.

We also offer high-voltage gate drivers – either standalone ICs or circuit boards containing ICs, electrical isolation components and other circuitry – used to operate high-voltage switches such as insulated-gate bipolar transistors (IGBTs). These combinations of switches and drivers are used for power conversion in high-power applications (i.e., power levels ranging from a few kilowatts up to one gigawatt) such as industrial motors, solar- and wind-power systems, electric vehicles and high-voltage DC transmission systems.

Our products bring a number of important benefits to the power-conversion market compared with less advanced alternatives, including reduced component count and design complexity, smaller size, higher reliability and reduced time-to-market. Our products also improve the energy efficiency of power converters, helping our customers meet the increasingly stringent efficiency standards that have been adopted around the world for many electronic products, and improving the efficacy of renewable-energy systems, electric vehicles and other high-power applications.

While the size of our addressable market fluctuates with changes in macroeconomic and industry conditions, the market has generally exhibited a modest growth rate over time as growth in the unit volume of power converters has been offset to a large degree by reductions in the average selling price of components in this market. Therefore, the growth of our business depends largely on increasing our penetration of the addressable market that we serve and on enlarging our addressable market. Our growth strategy includes the following elements:

- Increase our penetration of the markets we serve. We currently address AC-DC power-supply applications with power outputs up to approximately 500 watts, and gate-driver applications of ten kilowatts and higher. Through our R&D efforts, we seek to introduce more advanced products for this market that offer higher levels of integration and performance compared to earlier products. We also continue to expand our sales and application-engineering staff and our network of distributors, as well as our offerings of technical documentation and design-support tools and services to help customers use our products. These tools and services include our PI Expert™ design software, which we offer free of charge, and our transformer-sample service.

Our market-penetration strategy also includes capitalizing on the importance of energy efficiency in the power conversion market. For example, our EcoSmart™ technology drastically reduces the amount of energy consumed by electronic products when they are not in use, helping our customers comply with regulations that seek to curb this so-called “standby” energy consumption. Our gate-driver products also offer significant improvements in efficiency compared to many competing alternatives, enhancing the efficiency of high-power applications such as industrial motor drives while improving the efficacy of renewable-energy systems and electric transportation applications.

- Increase the size of our addressable market. Prior to 2010 our addressable market consisted of AC-DC applications with up to about 50 watts of output, a served available market ("SAM") opportunity of $1.5 billion. Since that time we have expanded our SAM to approximately $3 billion through a variety of means. These include the introduction of products that enable us to address higher-power AC-DC applications (such as our Hiper™ product families, which address applications up to about 500 watts) and our entry into the high-power gate-driver market through the acquisition of CT Concept Technologie AG in 2012. In 2016 we introduced the SCALE-iDriver™ family of gate-driver ICs, which enables us to address applications between approximately 10 kilowatts and 100 kilowatts, whereas previously our gate-driver products were primarily for applications above 100 kilowatts.

Also contributing to our SAM expansion has been the emergence of new applications within the power ranges that our products can address. For example, markets such as LED lighting, "smart" utility meters, battery-powered lawn equipment and bicycles, and USB power ports (installed alongside traditional AC wall outlets) can incorporate our products, while the increased use of electronic intelligence and controls in consumer appliances has also enhanced our SAM. Finally, we have enhanced our SAM by increasing the level of integration of our products, which in turn increases their value. For example, our InnoSwitch™ ICs integrate circuitry from the secondary, or low-voltage, side of AC-DC power supplies, whereas earlier product families integrated circuitry only on the primary, or high-voltage side.

We intend to continue expanding our SAM in the years ahead through all of the means described above.

Our quarterly operating results are difficult to predict and subject to significant fluctuations. We plan our production and inventory levels based on internal forecasts of projected customer demand, which are highly unpredictable and can fluctuate substantially. Customers typically may cancel or reschedule orders on short notice without significant penalty and, conversely, often place orders with very short lead times to delivery. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile. Furthermore, because our industry is intensely price-sensitive, our gross margin (gross profit divided by net revenues) is subject to change based on the relative pricing of solutions that compete with ours. Variations in product mix, end-market mix and customer mix can also cause our gross margin to fluctuate. Because we purchase a large percentage of our silicon wafers from foundries located in Japan, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. Changes in the prices of raw materials used in our products, such as copper and gold, can also affect our gross margin. Although our wafer-fabrication and assembly operations are outsourced, as are most of our test operations, a portion of our production costs are fixed in nature. As a result, our unit costs and gross margin are impacted by the volume of units we produce.

Recent Results

Our net revenues were $107.6 million and $97.6 million in the three months ended June 30, 2017 and 2016, respectively, and $212.3 million and $185.6 million in the six months ended June 30, 2017 and 2016, respectively. The increase in revenues for the three-month period was primarily due to higher unit sales into the consumer and industrial end-markets, driven by growth in revenue from consumer appliances and a broad range of industrial applications. For the six-month period, the increase was driven by growth in the above-mentioned categories as well as the communications category, reflecting growth in rapid-charging applications for the smartphone market. Growth in both the three- and six-month periods was partially offset by lower sales for computer applications, reflecting reduced demand for power supplies for desktop computers.

Our top ten customers, including distributors that resell to original equipment manufacturers (OEMs) and merchant power supply manufacturers, accounted for approximately 57% of our net revenues in each of the three and six months ended June 30, 2017, and approximately 62% of net revenues in each of the respective corresponding periods of 2016. Our top customer, a distributor of our products, accounted for approximately16% and 17% of our net revenues in the three and six months ended June 30, 2017, respectively, and 19% and 21% in the three and six months ended June 30, 2016, respectively. International sales accounted for 96% of our net revenues in each of the three and six months ended June 30, 2017, and June 30, 2016.

Our gross margin was 50% and 49% in the three months ended June 30, 2017 and 2016, respectively, and 49% and 50% in the six months ended June 30, 2017 and 2016, respectively. The increase in gross margin for the three-month period was due primarily to a favorable change in end-market mix, with a greater percentage of revenue coming from higher-margin end markets; the improvement was slightly offset by higher manufacturing costs stemming from a decline in the value of the U.S. dollar versus the Japanese yen in 2016, which subsequently increased the cost of silicon wafers purchased from our Japanese wafer fabrication

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foundries. The decrease in gross margin in the six-month period was driven primarily by the above mentioned decline in the value of the U.S. dollar versus the Japanese yen in 2016, partially offset by a favorable end-market mix.
Total operating expenses were $39.3 million and $36.0 million in the three months ended June 30, 2017 and 2016, respectively, and $76.8 million and $70.0 million in the six months ended June 30, 2016 and 2015, respectively. The increases were due primarily to higher salary and related expenses due to the expansion of our work force, increased legal expenses in connection with our litigation with ON Semiconductor and increased stock-based compensation expense related primarily to an increase in performance-based awards expected to vest as compared to 2016.

Critical Accounting Policies and Estimates

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

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

Our critical accounting policies are important to the portrayal of our financial condition and results of operations, and require us to make judgments and estimates about matters that are inherently uncertain. Except for the changes below, there have been no material changes to our critical accounting policies and estimates disclosed in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates" and Note 2, Summary of Significant Accounting Policies, in each case in our Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC on February 8, 2017.
We adopted Accounting Standards Codification 606, Revenue from Contracts with Customers (ASC 606-10), effective on January 1, 2017. Prior to the adoption of ASC 606-10, we deferred the recognition of revenue and the cost of revenue from certain sales until the distributors reported that they had sold the products to their customers (known as "sell-through"). Under ASC 606-10, we recognize revenue on sales to all distributors upon shipment and transfer of control (known as "sell-in"). As a result of this adoption, we revised our accounting policy for revenue recognition as detailed below.

Revenue Recognition

We apply the provisions of Accounting Standards Codification (ASC) 606-10, Revenue from Contracts with Customers, and all related appropriate guidance. We recognize revenue under the core principle to depict the transfer of control to our customers in an amount reflecting the consideration we expect to be entitled. In order to achieve that core principle, we apply the following five step approach: (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when a performance obligation is satisfied.
Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. We consider customer purchase orders, which in some cases are governed by master sales agreements, to be the contracts with a customer. In situations where sales are to a distributor, we have concluded that our contracts are with the distributor as we hold contracts bearing enforceable rights and obligations with only the distributor. As part of our consideration of the contract, we evaluate certain factors including the customer's ability to pay (or credit risk). For each contract, we consider the promise to transfer products, each of which is distinct, to be the identified performance obligations. In determining the transaction price we evaluate whether the price is subject to

refund or adjustment to determine the net consideration to which we expect to be entitled. As our standard payment terms are less than one year, we elected the practical expedient under ASC 606-10-32-18 to not assess

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whether a contract has a significant financing component. We allocate the transaction price to each distinct product based on their relative standalone selling price. We consider the product price as specified on the purchase order the standalone selling price as it is an observable input which depicts the price as if sold to a similar customer in similar circumstances. We recognize revenue when control of the product is transferred to the customer (i.e., when our performance obligation is satisfied), which typically occurs at shipment. Further, in determining whether control has transferred, we consider if there is a present right to payment and legal title, along with risks and rewards of ownership having transferred to the customer.

Frequently, we receive orders for products to be delivered over multiple dates that may extend across several reporting periods. We invoice for each delivery upon shipment and recognize revenue for each distinct product delivered, assuming transfer of control has occurred. As scheduled delivery dates are within one year, under the optional exemption provided by ASC 606-10-50-14 revenues allocated to future shipments of partially completed contracts are not disclosed.

Sales to international customers that are shipped from our facility outside of the United States are pursuant to EX Works, or EXW, shipping terms, meaning that control of the product transfers to the customer upon shipment from our foreign warehouse. Sales to international customers that we ship from our facility in California are pursuant to Delivered at Frontier, or DAF, shipping terms. As such, control of the product passes to the customer when the shipment reaches the destination country and we recognize revenue upon the arrival of the product in that country. Shipments to customers in the Americas are pursuant to Free on Board, or FOB, point of origin shipping terms meaning that we pass control to the customer upon shipment.

Sales to most distributors are made under terms allowing certain price adjustments and limited rights of return (known as “stock rotation”) of our products held in their inventory or upon sale to their end customers. We recognize revenue from sales to distributors upon the transfer of control to the distributor. Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At the time the distributor invoices its customer or soon thereafter, the distributor submits a “ship and debit” price adjustment claim to us to adjust the distributor’s cost from the standard price to the pre-approved lower price. After we verify that the claim was pre-approved, we issue a credit memo to the distributor for the ship and debit claim. In determining the transaction price, we consider ship and debit price adjustments to be variable consideration. Such price adjustments are estimated using the expected value method based on an analysis of actual ship and debit claims, at the distributor and product level, over a period of time considered adequate to account for current pricing and business trends. Historically, actual price adjustments for ship and debit claims relative to those estimated and included when determining the transaction price have not materially differed. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on our revenues and results of operations. Stock rotation rights grant the distributor the ability to return certain specified amounts of inventory. Stock rotation adjustments are an additional form of variable consideration and are also estimated using the expected value method based on historical return rates. Historically, these distributor stock rotation adjustments have not been material.

Sales to certain distributors are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, upon application of steps one through five above, product revenue is recognized upon shipment and transfer of control.

We generally provide an assurance warrant that our products will substantially conform to the published specifications for twelve months from the date of shipment. Our 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. As such, we do not record a specific warranty reserve or consider activities related to such warranty, if any, to be a separate performance obligation.

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Results of Operations

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Net revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of revenues | 50.3 % | 51.0 % | 51.0 % | 50.3 % |
| Gross profit | 49.7 % | 49.0 % | 49.0 % | 49.7 % |
| Operating expenses: | | | | |
| Research and development | 16.1 % | 16.3 % | 16.0 % | 16.5 % |
| Sales and marketing | 12.2 % | 12.3 % | 11.9 % | 12.6 % |
| General and administrative | 8.2 % | 8.3 % | 8.2 % | 8.6 % |
| Total operating expenses | 36.5 % | 36.9 % | 36.1 % | 37.7 % |
| Income from operations | 13.2 % | 12.1 % | 12.9 % | 12.0 % |
| Other income | 0.4 % | 0.2 % | 0.5 % | 0.3 % |
| Income before income taxes | 13.6 % | 12.3 % | 13.4 % | 12.3 % |
| Provision for income taxes | 0.7 % | 0.6 % | — % | 0.5 % |
| Net income | 12.9 % | 11.7 % | 13.4 % | 11.8 % |

Comparison of the Three and Six Months Ended June 30, 2017 and 2016

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three and six months ended June 30, 2017, were $107.6 million and $212.3 million, respectively, and $97.6 million and $185.6 million, respectively, for the corresponding periods of 2016. The increase in revenues for the three-month period was primarily due to higher unit sales into the consumer and industrial end-markets, driven by growth in revenue from consumer appliances and a broad range of industrial applications. For the six-month period, the increase was driven by growth in the above-mentioned categories as well as the communications category, reflecting growth in rapid-charging applications for the smartphone market. Growth in both the three- and six-month periods was partially offset by lower sales for computer applications, reflecting reduced demand for power supplies for desktop computers.

Our revenue mix by end market for the three- and six-month periods ended June 30, 2017, compared to the corresponding periods in 2016, was as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| End Market | 2017 | 2016 | 2017 | 2016 |
| Communications | 22% | 26% | 25% | 25% |
| Computer | 4 % | 6 % | 4 % | 6 % |
| Consumer | 41% | 36% | 39% | 37% |
| Industrial | 33% | 32% | 32% | 32% |

International sales, consisting of sales outside of the United States based on “bill to” customer locations, were $103.1 million and $203.9 million in the three and six months ended June 30, 2017, respectively, and $94.0 million and $178.4 million in the corresponding periods of 2016, respectively. Although power converters using our products are distributed to end markets worldwide, most are manufactured in Asia. As a result, sales to this region represented 78% and 79% of our net revenues in the three and six months ended June 30, 2017, respectively, and 82% and 80% of our net revenues in the corresponding periods of 2016, respectively. We expect international sales, and sales to the Asia region in particular, to continue to account for a large portion of our net revenues in the future.

Sales to distributors accounted for 80% and 78% of net revenues in the three and six months ended June 30, 2017, respectively, and 75% and 76% in the corresponding periods of 2016, respectively. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In the three and six months ended June 30, 2017, one customer, a distributor of our products, accounted for more than 10% of our net revenues. In the corresponding periods of 2016, two distributors each accounted for more than 10% of our net revenues. The following table discloses these customers’ percentage of revenues for the respective periods:

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| Customer | 2017 | 2016 | 2017 | 2016 |
| Avnet | 16% | 19% | 17% | 21% |
| Powertech Distribution Ltd. | * | 12% | * | 12% |

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

No other customers accounted for 10% or more of our net revenues in these periods.

Gross profit. Gross profit is net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our contracted foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facilities, amortization of acquired intangible assets, and overhead associated with the management of our supply chain. Gross margin is gross profit divided by net revenues. The table below compares gross profit and gross margin for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
| Net revenues | $107.6 | $97.6 | $212.3 | $185.6 |
| Gross profit | $53.4 | $47.8 | $103.9 | $92.3 |
| Gross margin | 49.7 % | 49.0 % | 49.0 % | 49.7 % |

The increase in gross margin for the three months ended June 30, 2017 was due primarily to a favorable change in end-market mix, with a greater percentage of revenue coming from higher-margin end markets. Slightly offset by higher manufacturing costs stemming from a decline in the value of the U.S. dollar versus the Japanese yen in 2016, which subsequently increased the cost of silicon wafers purchased from our Japanese wafer fabrication foundries. The decrease in gross margin in the six months ended June 30, 2017 was driven primarily by higher manufacturing costs stemming from a decline in the value of the U.S. dollar versus the Japanese yen in 2016, partially offset by a favorable end-market mix.

Research and development expenses. Research and development (“R&D”) expenses consist primarily of employee-related expenses, including stock-based compensation, and expensed material and facility costs associated with the development of new technologies and new products. We also record R&D expenses for prototype wafers related to new products until such products are released to production. The table below compares R&D expenses for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
| Net revenues | $107.6 | $97.6 | $212.3 | $185.6 |
| R&D expenses | $17.3 | $15.9 | $34.0 | $30.6 |
| R&D expenses as a % of net revenue | 16.1 % | 16.3 % | 16.0 % | 16.5 % |

R&D expenses, specifically salary and related expenses, increased in the three and six months ended June 30, 2017, as compared to the same periods in 2016, due primarily to the expansion of headcount in support of our product-development efforts.

Sales and marketing expenses. Sales and marketing (“S&M”) expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, amortization of intangible assets and facilities expenses, including expenses associated with our regional sales and support offices. The table below compares S&M expenses for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|

| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|
| Net revenues | $107.6 | $97.6 | $212.3 | $185.6 |
| S&M expenses | $13.1 | $12.0 | $25.4 | $23.4 |
| S&M expenses as a % of net revenue | 12.2 % | 12.3 % | 11.9 % | 12.6 % |

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S&M expenses increased in the three and six months ended June 30, 2017, compared to the same periods in 2016, due primarily to the expansion of our sales force, resulting in higher salary and related expenses.
General and administrative expenses. General and administrative ("G&A") expenses consist primarily of employee-related expenses, including stock-based compensation expenses, for administration, finance, human resources and general management, as well as consulting, professional services, legal and audit expenses. The table below compares G&A expenses for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
| Net revenues | $107.6 | $97.6 | $212.3 | $185.6 |
| G&A expenses | $8.8 | $8.1 | $17.5 | $16.0 |
| G&A expenses as a % of net revenue | 8.2 % | 8.3 % | 8.2 % | 8.6 % |

G&A expenses increased in the three and six months ended June 30, 2017, compared to the same periods in 2016 due to increased stock-based compensation expense, primarily related to an increase in performance-based stock awards expected to vest. Increased legal expenses related to our litigation with ON Semiconductor also contributed to the increase in the six-month period.
Other income. Other income consists primarily of interest income earned on cash and cash equivalents, marketable securities and other investments, and foreign exchange gains or losses. The table below compares other income for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
| Net revenues | $107.6 | $97.6 | $212.3 | $185.6 |
| Other income | $0.5 | $0.2 | $1.0 | $0.5 |
| Other income as a % of net revenue | 0.4 % | 0.2 % | 0.5 % | 0.3 % |

Other income increased in the three and six months ended June 30, 2017, compared to the same periods in 2016 due to an increase in interest income reflecting an increase in our cash and investment balances along with an increase in interest rates earned on those balances.
Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes. The table below compares income-tax expense for the three and six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (dollars in millions) | 2017 | 2016 | 2017 | 2016 |
| Income before income taxes | $14.7 | $12.0 | $28.1 | $22.7 |
| Provision for income taxes | $0.8 | $0.6 | $0.1 | $0.9 |
| Effective tax rate | 5.2 % | 5.0 % | 0.3 % | 4.1 % |

Our effective tax rates for the three and six months ended June 30, 2017, were 5.2% and 0.3%, respectively. In the three and six months ended June 30, 2017, the effective tax rates were lower than the statutory federal income-tax rate of 35% primarily due to the beneficial impact of the geographic distribution of our world-wide earnings and the federal research and development tax credits. Additionally, in the three and six months ended June 30, 2017 the rate was favorably impacted by the recognition of excess tax benefits related to share-based payments of approximately $0.4 million and $1.4 million, respectively. Effective January 1, 2017, we adopted Accounting Standards Update 2016-09 (ASU 2016-09), Compensation - Stock Compensation, under which all excess tax benefits and tax deficiencies are recognized prospectively as income tax expense or benefit in the income statement. For additional details on our adoption of ASU 2016-09, refer to Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in our Notes to Unaudited Condensed Consolidated Financial Statements. Our effective tax rates for the three and six months ended June 30, 2016, were 5.0% and 4.1%, respectively. In the three and six months ended June 30, 2016, the effective tax rates were lower than the statutory federal income-tax rate of 35% due primarily to the geographic distribution of our world-wide earnings in lower tax jurisdictions and federal research tax credits.

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Liquidity and Capital Resources

As of June 30, 2017, we had $254.0 million in cash, cash equivalents and short-term marketable securities, an increase of approximately $3.5 million from $250.5 million as of December 31, 2016. As of June 30, 2017, we had working capital, defined as current assets less current liabilities, of $295.3 million, an increase of approximately $21.0 million from $274.3 million as of December 31, 2016.

Operating activities generated cash of $30.0 million in the six months ended June 30, 2017. Net income for this period was $28.0 million; we also incurred non-cash stock-based compensation, depreciation and amortization expenses of $11.3 million, $8.5 million and $3.2 million, respectively. Sources of cash also included a $3.2 million increase in taxes payable and accrued liabilities. These sources of cash were partially offset by a $12.2 million increase in accounts receivable due to increased shipments, an $8.3 million increase in prepaid expenses and a $3.6 million decrease in accounts payable due primarily to the timing of payments.

Operating activities generated cash of $43.9 million in the six months ended June 30, 2016. Net income for this period was $21.8 million; we also incurred non-cash depreciation, amortization and stock-based compensation expenses of $8.5 million, $3.4 million and $9.4 million, respectively. Sources of cash also included a $5.2 million decrease in inventories due to greater than expected sales and a $3.0 million increase in accounts payable due primarily to the timing of payments. These sources of cash were partially offset by a $6.3 million increase in accounts receivable due to increased shipments and a $1.6 million decrease in taxes payable due to taxes paid during the period.

Our investing activities in the six months ended June 30, 2017, resulted in a $56.3 million net use of cash, consisting of $33.4 million for purchases of marketable securities, net of maturities, and $22.9 million for purchases of property and equipment, primarily production-related machinery and equipment. Our investing activities in the six months ended June 30, 2016, resulted in an $18.2 million net use of cash, consisting of $13.3 million for purchases of marketable securities, net of maturities, and $4.9 million for purchases of property and equipment, primarily production-related machinery and equipment.

Our financing activities in the six months ended June 30, 2017, resulted in a $3.2 million net use of cash. Financing activities consisted of $8.3 million for the payment of dividends to stockholders, partially offset by proceeds of $5.1 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan. Our financing activities in the six months ended June 30, 2016, resulted in a $10.5 million net use of cash. Financing activities consisted of $7.5 million for the payment of dividends to stockholders and $6.4 million for the repurchase of our common stock, partially offset by proceeds of $3.4 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan.

On July 27, 2016, we entered into a credit agreement with a bank (the "Credit Agreement") that provides us with a $75.0 million revolving line of credit to use for general corporate purposes with a $20.0 million sub-limit for the issuance of standby and trade letters of credit. Our ability to borrow under the revolving line of credit is conditioned upon our compliance with specified covenants, including reporting and financial covenants, primarily a minimum liquidity measure and a debt to earnings ratio, with which we are currently in compliance. The Credit Agreement terminates on July 26, 2019; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of June 30, 2017, we had no amounts outstanding under our agreement.

In January 2016, our board of directors declared four quarterly cash dividends in the amount of $0.13 per share to be paid to stockholders of record at the end of each quarter in 2016. We paid a total of $15.1 million in cash dividends in 2016. In January 2017, our board of directors declared four quarterly cash dividends in the amount of $0.14 per share to be paid to stockholders of record at the end of each quarter in 2017. Dividend payouts of approximately $4.1 million and $4.2 million occurred on March 31, 2017 and June 30, 2017, respectively. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interests of our stockholders.

We did not repurchase any of our common stock during the three and six months ended June 30, 2017. As of June 30, 2017, we had approximately $23.6 million remaining in our repurchase program, which has no expiration date. In July 2017, our board of directors authorized the use of an additional $30.0 million for the repurchase of our common stock, with repurchases to be executed according to pre-defined price/volume guidelines. Authorization of future repurchase programs is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors.

As of June 30, 2017, we had a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately $17.4 million. A portion of the tax obligation is classified as long-term income taxes payable and a

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portion is recorded in deferred tax assets in our condensed consolidated balance sheet.

As of June 30, 2017, there were no material changes in our contractual commitments from those reported in our Annual Report on Form 10-K for the year ended December 31, 2016.

Our cash, cash equivalents and investment balances may change in future periods due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to future acquisitions. We expect continued sales growth in our foreign business and plan to use the earnings generated by our foreign subsidiaries to continue to fund both the working capital and growth needs of our foreign entities, along with providing funding for any future foreign acquisitions. We do not provide for U.S. taxes on our undistributed earnings of foreign subsidiaries that we intend to invest indefinitely outside the U.S., unless such taxes are otherwise required under U.S. tax law. A portion of our foreign subsidiaries current and future earnings may be remitted prospectively to the U.S. for domestic cash flow purposes and, accordingly, provided for the related U.S. taxes in our condensed consolidated financial statements. Currently the majority of our cash and marketable securities are held in the U.S. If we change our intent to invest our undistributed earnings outside the U.S. indefinitely or if a greater amount of undistributed earnings are needed for U.S. operations than previously anticipated and for which U.S. taxes have not been recorded, we would be required to accrue or pay U.S. taxes (subject to an adjustment for foreign tax credits, where applicable) and withholding taxes payable to various foreign countries on some or all of these undistributed earnings. As of December 31, 2016, we had undistributed earnings of foreign subsidiaries that are indefinitely invested outside of the U.S. of approximately $265.0 million.

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

Off-Balance-Sheet Arrangements

As of June 30, 2017, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has not been a material change in our exposure to foreign currency exchange and interest rate risks from that described in our Annual Report on Form 10-K for the year ended December 31, 2016.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months at the date of purchase are classified as short-term investments. We generally hold securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments, and therefore we classify our investment portfolio as available-for-sale. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. Our portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. At June 30, 2017, and

December 31, 2016, we held primarily cash equivalents and short-term investments with fixed interest rates.
Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. We monitor our investments per our above-mentioned investment policy; therefore, if market interest rates were to increase or decrease by 10% from interest rates as of June 30, 2017, or December 31, 2016, the increase or decrease in the fair market value

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of our portfolio on these dates would not have been material. We monitor our investments for impairment on a periodic basis. Refer to Note 5, Marketable Securities, in our Notes to Unaudited Condensed Consolidated Financial Statements, for a tabular presentation of our available-for-sale investments and the expected maturity dates.

Foreign Currency Exchange Risk. As of June 30, 2017, our primary transactional currency was U.S. dollars; in addition, we hold cash in Swiss francs and euro. We maintain cash denominated in Swiss francs and euro to fund the operations of our Swiss subsidiary. The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc and euro is recorded in other income in our condensed consolidated statements of income.

We have sales offices in various other foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. Cash balances held in foreign countries are subject to local banking laws and may bear higher or lower risk than cash deposited in the United States. From time to time we may enter into foreign currency hedging contracts to hedge certain foreign currency transactions. As of June 30, 2017, and December 31, 2016, we did not have an open foreign currency hedge program utilizing foreign currency forward exchange contracts.

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

Nevertheless, as a result of our above-mentioned supplier agreements, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. All else being equal, a 10% change in the value of the U.S. dollar compared to the Japanese yen would result in a corresponding change in our gross margin of approximately 1.0%; this sensitivity may increase or decrease depending on the percentage of our wafer supply that we purchase from some of our Japanese suppliers and could subject our gross profit and operating results to the potential for material fluctuations.

## ITEM 4. CONTROLS AND PROCEDURES

### Limitation on Effectiveness of Controls

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

### Evaluation of Disclosure Controls and Procedures

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

### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2017, which were identified in connection with management’s evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

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## ITEM 1. LEGAL PROCEEDINGS

Information with respect to this item may be found in Note 12, Legal Proceedings and Contingencies, in our Notes to Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

## ITEM 1A. RISK FACTORS

As of the date of this filing, the risk factors have not changed substantively from those disclosed in Part 1 Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2016, which risk factors are incorporated by reference in this report.

## ITEM 6. EXHIBITS

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

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SIGNATURES

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

POWER INTEGRATIONS, INC.

Dated: July 27, 2017 By: /s/ SANDEEP NAYYAR

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

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INDEX TO EXHIBITS

| EXHIBIT NUMBER | Exhibit Description | Incorporation by Reference | | | | Filed Herewith |
|---|---|---|---|---|---|---|
| | | Form | File Number | Exhibit/Appendix Reference | Filing Date | |
| 3.1 | Restated Certificate of Incorporation. | 10-K | 000-23441 | 3.1 | 2/29/2012 | |
| 3.2 | Amended and Restated Bylaws. | 8-K | 000-23441 | 3.1 | 4/26/2013 | |
| 4.1 | Reference is made to Exhibits 3.1 to 3.2. | | | | | |
| 10.1 | May 2017 RSU grants to named executive officers. | 10-Q | 000-23441 | Part II, Item 5 | 5/5/2017 | |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | | | | | X |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | | | | | X |
| 32.1** | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | | | | | X |
| 32.2** | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | | | | | X |
| 101.INS | XBRL Instance Document | | | | | X |
| 101.SCH | XBRL Taxonomy Extension Schema Document | | | | | X |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | | | | | X |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | | | | | X |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | | | | | X |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | | | | | X |

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

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

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