

POWER INTEGRATIONS INC  
Form 10-Q  
April 30, 2015  
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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)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2015

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-23441

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

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DELAWARE (State or other jurisdiction of Incorporation or organization) 5245 Hellyer Avenue, San Jose, California, 95138 (Address of principal executive offices) (Zip code) (408) 414-9200 (Registrant's telephone number, including area code)	94-3065014 (I.R.S. Employer Identification No.)
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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  NO

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

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

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

(Do not check if a smaller reporting company)

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

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

Class	Shares Outstanding at April 17, 2015
Common Stock, \$0.001 par value	29,429,013



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

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## POWER INTEGRATIONS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

	March 31, 2015	December 31, 2014
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$85,637	\$60,708
Short-term marketable securities	87,560	114,575
Accounts receivable, net of allowances of \$186 and \$191 in 2015 and 2014, respectively (Note 2)	12,631	10,186
Inventories	65,009	64,025
Deferred tax assets	39	39
Prepaid expenses and other current assets	11,458	16,379
Total current assets	262,334	265,912
PROPERTY AND EQUIPMENT, net	94,179	95,823
INTANGIBLE ASSETS, net	42,758	35,524
GOODWILL	91,849	80,599
DEFERRED TAX ASSETS	11,265	11,562
OTHER ASSETS	4,789	4,243
Total assets	\$507,174	\$493,663
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$23,907	\$21,980
Accrued payroll and related expenses	8,815	9,071
Taxes payable	2,930	2,963
Deferred tax liabilities	2,187	2,193
Deferred income on sales to distributors	17,254	15,223
Other accrued liabilities	3,834	3,730
Total current liabilities	58,927	55,160
LONG-TERM INCOME TAXES PAYABLE	746	743
DEFERRED TAX LIABILITIES	4,059	4,272
OTHER LIABILITIES	2,960	2,812
Total liabilities	66,692	62,987
COMMITMENTS AND CONTINGENCIES (Notes 9, 11, 12 and 15)		
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock	29	29
Additional paid-in capital	178,816	171,938
Accumulated other comprehensive loss	(1,031	) (1,136
Retained earnings	262,668	259,845
Total stockholders' equity	440,482	430,676
Total liabilities and stockholders' equity	\$507,174	\$493,663

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)  
 (In thousands, except per share amounts)

	Three Months Ended March 31,	
	2015	2014
NET REVENUES	\$82,557	\$83,073
COST OF REVENUES	40,265	37,096
GROSS PROFIT	42,292	45,977
OPERATING EXPENSES:		
Research and development	14,941	13,490
Sales and marketing	12,113	12,110
General and administrative	8,281	7,646
Total operating expenses	35,335	33,246
INCOME FROM OPERATIONS	6,957	12,731
OTHER INCOME (EXPENSE)		
Other income (expense), net	(223	) 257
Total other income (expense)	(223	) 257
INCOME BEFORE INCOME TAXES	6,734	12,988
PROVISION FOR INCOME TAXES	391	625
NET INCOME	\$6,343	\$12,363
EARNINGS PER SHARE:		
Basic	\$0.22	\$0.41
Diluted	\$0.21	\$0.40
SHARES USED IN PER SHARE CALCULATION:		
Basic	29,309	30,239
Diluted	30,058	31,167

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)  
 (In thousands)

	Three Months Ended March 31,	
	2015	2014
Net income	\$6,343	\$12,363
Other comprehensive income, net of tax:		
Foreign currency translation adjustments, net of \$0 tax in the three months ended March 31, 2015 and 2014 (Note 2)	35	(6 )
Unrealized gain on marketable securities, net of \$0 tax in the three months ended March 31, 2015 and 2014 (Note 2)	56	147
Amortization of defined benefit pension items, net of tax of \$4 and \$4 in the three months ended March 31, 2015 and 2014, respectively (Note 2)	14	14
Total other comprehensive income	105	155
Total comprehensive income	\$6,448	\$12,518

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)  
 (In thousands)

	Three Months Ended March 31,	
	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$6,343	\$12,363
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4,032	3,971
Amortization of intangibles	1,786	1,856
Loss on sale of property and equipment	—	159
Stock-based compensation expense	4,391	3,915
Amortization of premium on marketable securities	286	394
Deferred income taxes	77	3,864
Reduction in accounts receivable allowances	(5	) (15
Tax deficiency associated with employee stock plans	(189	) —
Change in operating assets and liabilities:		
Accounts receivable	(550	) (4,017
Inventories	424	(5,652
Prepaid expenses and other assets	(227	) 1,825
Accounts payable	349	1,088
Taxes payable and accrued liabilities	(1,076	) (5,624
Deferred income on sales to distributors	2,031	2,116
Net cash provided by operating activities	17,672	16,243
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(3,322	) (4,465
Payment for acquisition, net of cash acquired (Note 10)	(15,365	) —
Purchases of marketable securities	—	(24,751
Proceeds from sales and maturities of marketable securities	26,785	—
Net cash provided by (used in) investing activities	8,098	(29,216
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock under employee stock plans	3,519	7,045
Repurchase of common stock	(841	) —
Payments of dividends to stockholders	(3,519	) (3,033
Net cash provided by (used in) financing activities	(841	) 4,012
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>24,929</b>	<b>(8,961</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>60,708</b>	<b>92,928</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$85,637</b>	<b>\$83,967</b>
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>		
Unpaid property and equipment	\$1,295	\$4,602
Unpaid CamSemi purchase consideration (Note 10)	\$184	\$—
Loan applied to CamSemi purchase price (Note 10)	\$6,600	\$—
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid (refund) for income taxes, net	\$657	\$(1,942

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 Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2014, included in its Form 10-K filed on February 10, 2015, with the Securities and Exchange Commission.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

No material changes have been made to the Company's significant accounting policies disclosed in Note 2, Summary of Significant Accounting Policies, in its Annual Report on Form 10-K, filed on February 10, 2015, for the year ended December 31, 2014. The accounting policy information below is to aid in the understanding of the financial information disclosed.

## Cash and Cash Equivalents

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

## Marketable Securities

The Company generally holds securities until maturity; however, they may be sold under certain circumstances including, but not limited to, when necessary for the funding of acquisitions, stock repurchases and other strategic investments. As a result the Company classifies its investment portfolio as available-for-sale. The Company classifies all investments with an original maturity date greater than three months as short-term marketable securities in its Condensed Consolidated Balance Sheets. As of March 31, 2015, and December 31, 2014, the Company's marketable securities consisted primarily of highly liquid corporate securities, commercial paper and other high-quality commercial securities.

Amortized cost and estimated fair market value of investments classified as available-for-sale at March 31, 2015, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains      Losses		Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	\$27,538	\$—	\$—	\$27,538
Corporate securities	2,257	1	—	2,258
Total	29,795	1	—	29,796

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Investments due in 4-12 months:				
Corporate securities	56,824	93	—	56,917
Total	56,824	93	—	56,917
Investments due between 12 months and 5-years:				
Corporate securities	28,338	51	(4	) 28,385
Total	28,338	51	(4	) 28,385
Total marketable securities	\$ 114,957	\$ 145	\$(4	) \$ 115,098

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Corporate securities and commercial paper (as presented in the table above) have been included within marketable securities and cash and cash equivalents, respectively on the condensed consolidated balance sheets.

Amortized cost and estimated fair market value of investments classified as available-for-sale at December 31, 2014, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Market Value
Investments due in 4-12 months:				
Corporate securities	\$30,233	\$36	\$—	\$30,269
Total	30,233	36	—	30,269
Investments due between 12 months and 5-years:				
Corporate securities	84,259	92	(45)	84,306
Total	84,259	92	(45)	84,306
Total marketable securities	\$114,492	\$128	\$(45)	\$114,575

As of March 31, 2015, and December 31, 2014, the Company evaluated the nature of the investments with a loss position, which were primarily high-quality corporate securities, and determined the unrealized losses were not other-than-temporary.

## Revenue Recognition

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Approximately 75% of the Company's net product sales were made to distributors in the three months ended March 31, 2015, and 75% in the twelve months ended December 31, 2014. The Company applies the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the Company's customer. The Company evaluates whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to collectability, the Company performs credit checks for new customers and performs ongoing evaluations of its existing customers' financial condition and requires letters of credit whenever deemed necessary.

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

Sales to most of the Company's distributors are made under terms allowing certain price adjustments and rights of return on the Company's products held by its distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until the Company's distributors report that they have sold the Company's products to their customers. The Company's recognition of such distributor revenue is based on point of sale reports received from the distributors, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to the Company except pursuant to warranty terms. The gross profit that is deferred as a result of this policy is reflected as "deferred income on sales to distributors" in the accompanying condensed consolidated balance sheets. The total deferred revenue as of March 31, 2015, and December 31, 2014, was approximately \$30.0 million and \$25.0

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

million, respectively. The total deferred cost as of March 31, 2015, and December 31, 2014, was approximately \$12.7 million and \$9.8 million, respectively.

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

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

#### Common Stock Repurchases and Cash Dividend

In October 2012, the Company's board of directors authorized the use of \$50.0 million for the repurchase of the Company's common stock, and in the year ended December 31, 2014, the Company's board of directors authorized the use of an additional \$75.0 million for this purpose, with repurchases to be executed according to pre-defined price/volume guidelines. In the year ended December 31, 2014, the Company purchased 1.6 million shares for \$80.8 million, and in the three months ended March 31, 2015, the Company purchased approximately 17,000 shares for \$0.8 million. As of March 31, 2015, the Company had \$22.9 million remaining on its repurchase authorization. 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.

In October 2013, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.10 per share to be paid to stockholders of record at the end of each quarter in 2014. Dividend payouts totaling approximately \$3.0 million each were paid on March 31, 2014 and June 30, 2014. In April 2014, the Company's board of directors increased the quarterly dividends for the third and fourth quarters of 2014 to \$0.12 per share. Dividend payouts totaling approximately \$3.6 million and \$3.5 million were paid on September 30, 2014 and December 31, 2014, respectively.

In January 2015, the Company's board of directors extended the \$0.12 quarterly dividend through each quarter in 2015. A dividend payout totaling \$3.5 million was paid on March 31, 2015. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interests of the Company's stockholders.

#### Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company evaluates its estimates, including

those related to revenue recognition, income tax, stock-based compensation and inventories. These estimates are based on historical facts and various other assumptions that the Company believes to be reasonable at the time the estimates are made.

Components of the Company's Condensed Consolidated Balance Sheet

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounts Receivable (in thousands):

	March 31, 2015	December 31, 2014
Accounts receivable trade	\$47,058	\$38,344
Accrued ship and debit and rebate claims	(34,241	) (27,967
Allowance for doubtful accounts	(186	) (191
Total	\$12,631	\$10,186

Prepaid Expenses and Other Current Assets (in thousands):

	March 31, 2015	December 31, 2014
Prepaid legal fees	\$41	\$1,506
Loan to Cambridge Semiconductor (Note 10)	—	6,600
Prepaid income tax	3,208	3,208
Prepaid maintenance agreements	1,229	1,023
Interest receivable	387	664
VAT receivable	901	987
Supplier prepayment	1,466	800
Other	4,226	1,591
Total	\$11,458	\$16,379

Changes in accumulated other comprehensive income (loss) for the three months ended March 31, 2015 and 2014 (in thousands):

	Unrealized Gains and Losses on Marketable Securities Three Months Ended March 31,		Defined Benefit Pension Items Three Months Ended March 31,		Foreign Currency Items Three Months Ended March 31,		Total Three Months Ended March 31,	
	2015	2014	2015	2014	2015	2014	2015	2014
Beginning balance at January 1,	\$83	\$210	\$(1,240)	\$(780 )	\$21	\$100	\$(1,136 )	\$(470 )
Other comprehensive income (loss) before reclassifications	56	147	—	—	35	(6 )	91	141
Amounts reclassified from accumulated other comprehensive income	—	—	14	(1) 14	(1)—	—	14	14
Net-current period other comprehensive income (loss)	56	147	14	14	35	(6 )	105	155
Ending balance at March 31,	\$139	\$357	\$(1,226)	\$(766 )	\$56	\$94	\$(1,031 )	\$(315 )



(1) This component of accumulated other comprehensive income is included in the computation of net periodic pension cost for the three months ended March 31, 2015 and 2014.

3. STOCK PLANS AND SHARE-BASED COMPENSATION:

Stock Plans

As of March 31, 2015, the Company had two stock-based compensation plans (the "Plans") which are described below.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2007 Equity Incentive Plan

The 2007 Equity Incentive Plan (the "2007 Plan") was adopted by the board of directors on September 10, 2007, and approved by the stockholders on November 7, 2007, as an amendment and restatement of the 1997 Stock Option Plan (the "1997 Plan"). The 2007 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards ("RSUs"), stock appreciation rights, performance-based awards ("PSUs"), long-term performance based awards ("PRSUs") and other stock awards to employees, directors and consultants. As of March 31, 2015, the maximum remaining number of shares that may be issued under the 2007 Plan was 6,582,346 shares, which includes options granted but not exercised and awards granted but unvested and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options and stock awards under the 1997 Plan. Pursuant to the 2007 Plan, the exercise price for incentive stock options and non-statutory stock options is generally at least 100% of the fair market value of the underlying shares on the date of grant. Options generally vest over 48 months measured from the date of grant. Options generally expire no later than ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

Beginning January 27, 2009, grants pursuant to the Directors Equity Compensation Program (which was adopted by the board of directors on January 27, 2009) to non-employee directors have been made primarily under the 2007 Plan. The Directors Equity Compensation Program provides for grants to outside directors as follows: effective annually, upon the first trading day of July, each outside director receives a grant of an equity award with an aggregate value of \$100,000, which will become exercisable or vest immediately prior to the Company's next annual meeting of stockholders, subject to the director's continued service. At each outside director's election, such award may consist entirely of RSUs or entirely of stock options. The quantity of options would be calculated by dividing \$100,000 by the Black-Scholes value on the date of grant. The quantity of RSUs issued would be calculated by dividing \$100,000 by the grant-date fair value. Further, on the date of election of a new outside director, such new director would receive such grant as continuing outside directors receive on the first trading day of July; provided, however, that such grant is prorated for the portion of the year that such new outside director will serve until the next first trading day of July. The Directors Equity Compensation Program will remain in effect at the discretion of the board of directors or the compensation committee of the board.

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

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the "Purchase Plan"), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee's compensation, to the purchase of shares of the Company's common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company's common stock on the first day of each offering period, or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Each offering period consists of one purchase period of approximately six months' duration. An aggregate of 3,000,000 shares of common stock were reserved for issuance to employees under the Purchase Plan. As of March 31, 2015, 2,747,784 shares had been purchased and 252,216 shares were reserved for future issuance under the Purchase Plan.

Stock-Based Compensation

The Company applies the provisions of ASC 718-10. Under the provisions of ASC 718-10, the Company recognizes the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. The Company uses estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation expense to recognize. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award, and uses historical data to estimate pre-vesting forfeitures, recognizing expense only for those awards that are expected to vest.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Determining Fair Value of Stock Options

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

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

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

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

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

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three months ended March 31, 2015, and March 31, 2014 (in thousands).

	Three Months Ended	
	March 31,	
	2015	2014
Cost of revenues	\$249	\$219
Research and development	1,391	1,212
Sales and marketing	1,012	935
General and administrative	1,739	1,549
Total stock-based compensation expense	\$4,391	\$3,915

Stock-based compensation expense in the three months ended March 31, 2015, was \$4.4 million (comprising approximately \$0.2 million related to stock options, \$0.6 million related to annual and long-term performance awards, \$3.3 million related to RSUs and \$0.3 million related to the Purchase Plan). Stock-based compensation expense in the three months ended March 31, 2014, was \$3.9 million (comprising approximately \$0.5 million related to stock options, \$0.5 million related to annual and long-term performance-based awards, \$2.6 million related to RSUs and \$0.3 million related to the Purchase Plan).

The following table summarizes total compensation expense related to unvested awards not yet recognized, net of expected forfeitures, and the weighted-average period over which it is expected to be recognized as of March 31, 2015.

	March 31, 2015	Weighted Average
	Unrecognized	Remaining
	Compensation	Recognition
	Expense for Unvested	Period
	Awards	(In years)
	(In thousands)	
Options	\$587	0.94
Performance-based awards	1,256	0.75

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Long-term performance-based awards	3,879	2.26
Restricted stock units	22,379	2.29
Purchase plan	434	0.50
Total unrecognized compensation expense	\$28,535	

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended	
	March 31,	
	2015	2014
Risk-free interest rates	0.07%	0.07%
Expected volatility rates	34%	30%
Expected dividend yield	0.89%	0.66%
Expected term of purchase right (in years)	0.5	0.5
Weighted-average estimated fair value of purchase rights	\$12.89	\$13.31

The Company did not grant stock options in the three months ended March 31, 2015, or March 31, 2014, and therefore no fair-value assumptions were reported.

A summary of stock option activity under the Plans, excluding performance-based awards and restricted stock units, as of March 31, 2015, and changes during the three 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, 2015	1,344	\$27.27		
Granted	—	—		
Exercised	(49	) \$21.24		
Forfeited or expired	—	—		
Outstanding at March 31, 2015	1,295	\$27.49	3.42	\$31,846
Exercisable at March 31, 2015	1,256	\$27.05	3.31	\$31,453
Vested and expected to vest at March 31, 2015	1,294	\$27.48	3.42	\$31,837

The Company did not grant stock options in the three months ended March 31, 2015, and March 31, 2014. Beginning in 2010 the Company's equity grants to new hires and its annual incentive grants to non-executive employees have been primarily in the form of RSUs. The total intrinsic value of options exercised during the three months ended March 31, 2015 and 2014, was approximately \$1.6 million and \$5.8 million, respectively.

## Performance-based Awards ("PSUs")

Under the performance-based awards program, the Company grants awards in the first half of the performance year in an amount equal to twice the target number of shares to be issued if the target performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the targeted number depending on the Company's performance. In 2015, the performance metrics of this program are annual targets consisting of net revenue, non-GAAP operating income and strategic goals. Each performance-based award granted from the 2007 Plan will reduce the number of shares available for issuance under the 2007 Plan by two shares.

During the three months ended March 31, 2015, the Company granted approximately 50,000 annual performance-based awards to the Company's executives. As the net revenue, non-GAAP operating earnings and strategic goals are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, are recorded throughout the year depending on the number of shares expected to vest based on progress

toward the performance targets. The cost of performance-based awards is determined using the fair value of the Company's common stock on the grant date, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

In January 2015, it was determined that the Company had not reached the minimum level of the established 2014 performance targets (consisting of revenue and non-GAAP operating income). Accordingly, no shares subject to performance-

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

based awards granted in connection with the 2014 performance based incentive plan were released to the Company's employees and executives in 2015.

A summary of performance-based awards outstanding as of March 31, 2015, and activity during the three 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, 2015	—	—		
Granted	50	\$53.74		
Vested	—	—		
Change in units due to performance achievement for PSUs vested in the year	—	—		
Forfeited or expired	—	—		
Outstanding at March 31, 2015	50	\$53.74	0.75	\$2,614
Outstanding and expected to vest at March 31, 2015	30		0.75	\$1,569

The weighted-average grant-date fair value per share of performance-based awards granted in the three months ended March 31, 2015 and 2014, was approximately \$53.74 and \$58.55, respectively. There were no awards released in the three months ended March 31, 2015, as the 2014 net revenue and non-GAAP operating earnings did not meet the minimum targets established for such awards. The grant-date fair value of awards released, which were fully vested, in the three months ended March 31, 2014, was approximately \$3.2 million.

## Long-Term Performance-based Awards ("PRSUs")

In the first quarter of 2014 the Company began granting long-term performance-based 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 Plan's established revenue targets. The PRSUs were granted in an amount equal to twice the target number of shares to be issued if the target 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 targeted number. The performance goals for PRSUs granted in fiscal 2015 and 2014 were based on the Company's annual revenue growth. Each long-term performance-based award granted from the 2007 Plan will reduce the number of shares available for issuance under the 2007 Plan by two shares.

Recipients of a PRSU award generally must remain employed by the Company on a continuous basis through the end of the applicable three-year performance period in order to receive shares subject to that award. Expenses associated with these awards, net of estimated forfeitures, are recorded throughout the year depending on the number of shares expected to vest based on progress toward the performance target. The cost of long-term performance-based awards is determined using the fair value of the Company's common stock on the grant date, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.





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A summary of long-term performance-based awards outstanding as of March 31, 2015, and activity during the three 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, 2015	61	\$55.51		
Granted	65	\$52.80		
Vested	—	—		
Forfeited or expired	—	—		
Outstanding at March 31, 2015	126	\$54.12	2.26	\$6,546
Outstanding and expected to vest at March 31, 2015	102		2.25	\$5,305

The weighted-average grant-date fair value per share of long-term performance-based awards granted in the three months ended March 31, 2015 and 2014, was approximately \$52.80 and \$57.76, respectively. No PRSUs vested in the three months ended March 31, 2015, or March 31, 2014.

## Restricted Stock Units ("RSUs")

The Company grants restricted stock units to employees under the 2007 Plan. RSUs granted to employees typically vest ratably over a four-year period, and are converted into shares of the Company's common stock upon vesting on a one-for-one basis subject to the employee's continued service with the Company over that period. The fair value of RSUs is determined using the fair value of the Company's common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. Compensation expense is recognized on a straight-line basis over the requisite service period of each grant adjusted for estimated forfeitures. Each RSU award granted from the 2007 plan will reduce the number of shares available for issuance under the 2007 Plan by 2 shares.

A summary of RSUs outstanding as of March 31, 2015, and changes during the three months then ended, are as follows:

	Shares (in thousands)	Weighted- Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2015	692	\$43.86		
Granted	104	\$52.25		
Vested	(64)	\$42.70		
Forfeited or expired	(3)	\$41.23		
Outstanding at March 31, 2015	729	\$45.16	1.45	\$37,987
Outstanding and expected to vest at March 31, 2015	682		1.26	\$35,544

The weighted-average grant-date fair value per share of RSUs awarded in the three months ended March 31, 2015 and 2014, was approximately \$52.25 and \$57.05, respectively. The grant-date fair value of RSUs vested in the three months ended March 31, 2015 and 2014, was approximately \$2.7 million and \$1.6 million, respectively.

## 4. FAIR VALUE MEASUREMENTS:

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's cash and 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 type of instrument valued based on quoted market prices in active markets primarily includes money market securities. This type of instrument is generally classified within Level 1 of the fair-value hierarchy. The types of instruments valued based on other observable inputs (Level 2 of the fair-value hierarchy) generally include investment-grade corporate bonds and government, state, municipal and provincial obligations. Such types of investments are valued by using a multi-dimensional relational model, the inputs are primarily benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data including market research publications. The Company's investments classified as Level 1 and Level 2 are available-for-sale investments, and were recorded at fair market value.

The fair-value hierarchy of the Company's marketable securities at March 31, 2015, and December 31, 2014, was as follows (in thousands):

Description	Fair Value Measurement at March 31, 2015		
	March 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Commercial paper	\$27,538	\$—	\$27,538
Money market funds	3,419	3,419	—
Corporate securities	87,560	—	87,560
Total	\$118,517	\$3,419	\$115,098

Description	Fair Value Measurement at December 31, 2014		
	December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	\$3,370	\$3,370	\$—
Corporate securities	114,575	—	114,575
Total	\$117,945	\$3,370	\$114,575

The Company did not transfer any investments between Level 1 and Level 2 of the fair-value hierarchy in the three months ended March 31, 2015, and the twelve months ended December 31, 2014.

**5. INVENTORIES:**

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



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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inventories consist of the following (in thousands):

	March 31, 2015	December 31, 2014
Raw materials	\$21,435	\$21,127
Work-in-process	16,066	14,643
Finished goods	27,508	28,255
Total	\$65,009	\$64,025

## 6. GOODWILL AND INTANGIBLE ASSETS:

Goodwill increased during the three months ended March 31, 2015, due to the Company's acquisition of Cambridge Semiconductor Limited, or CamSemi (refer to Note 10, Acquisition, for details on the Company's CamSemi acquisition). Changes in the carrying amount of goodwill during the three months ended March 31, 2015, are as follows (in thousands):

	Goodwill
Balance at December 31, 2014	\$80,599
Goodwill acquired during the period	11,250
Ending balance at March 31, 2015	\$91,849

Intangible assets consist primarily of developed technology, acquired licenses, customer relationships, trade name, in-process research and development and patent rights, and are reported net of accumulated amortization. In January 2015, the Company acquired CamSemi, resulting in the addition of the following intangible assets; developed technology of \$6.6 million, which will be amortized over a period of 3 - 7 years; and customer relationships of \$2.4 million, which will be amortized over a period of 5 years. The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the developed technology, acquired licenses, customer relationships, trade name and patent rights, which range from two to 12 years, with the exception of \$1.3 million for the purchase of an internet domain name (the cost to acquire the domain name has been recorded as an intangible asset and will not be amortized as it has an indefinite useful life), and \$4.7 million of in-process research and development. In-process research and development is assessed for impairment until the development is completed and products are available for sale, at which time the Company will begin to amortize the in-process research and development. The Company does not expect the amortization of in-process research and development to begin in 2015. Amortization for acquired intangible assets was approximately \$1.8 million and \$1.9 million in the three months ended March 31, 2015 and 2014, respectively. The Company does not believe there is any significant residual value associated with its finite-lived intangible assets:

	March 31, 2015			December 31, 2014		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(in thousands)					
Domain name	\$1,261	\$—	\$1,261	\$1,261	\$—	\$1,261
In-process research and development	4,690	—	4,690	4,690	—	4,690
Technology licenses	3,000	(2,700)	) 300	3,000	(2,625)	) 375
Patent rights	1,949	(1,949)	) —	1,949	(1,949)	) —
Developed technology	33,270	(8,790)	) 24,480	26,670	(7,828)	) 18,842
Customer relationships	20,030	(8,003)	) 12,027	17,610	(7,254)	) 10,356
Trade name	3,600	(3,600)	) —	3,600	(3,600)	) —
Total intangible assets	\$67,800	\$(25,042)	) \$42,758	\$58,780	\$(23,256)	) \$35,524



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The estimated future amortization expense related to finite-lived intangible assets at March 31, 2015, is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2015 (remaining 9 months)	\$5,133
2016	6,303
2017	5,904
2018	5,152
2019	4,753
Thereafter	9,562
Total (1)	\$36,807

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

## 7. SIGNIFICANT CUSTOMERS AND INTERNATIONAL SALES:

## Segment Reporting

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

## Customer Concentration

The Company's top ten customers accounted for approximately 60% and 59% of net revenues for the three months ended March 31, 2015 and 2014, respectively. A significant portion of these revenues are attributable to sales of the Company's products to distributors of electronic components. These distributors sell the Company's products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers.

One customer, a distributor of the Company's products, accounted for more than 10% of the Company's net revenues in the three months ended March 31, 2015 and 2014. The following table discloses that customer's percentage of revenues for the respective periods:

Customer	Three Months Ended			
	March 31,			
	2015		2014	
Avnet	22	%	19	%

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

## Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company has cash investment policies that limit cash investments to low-risk investments. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial



conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exposure related to its customers. As of March 31, 2015, and December 31, 2014, 65% and 66%, respectively, of accounts receivable were concentrated with the Company's top 10 customers.

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

Customer	March 31, 2015	December 31, 2014	
Avnet	23	% 22	%
ATM Electronic Corporation	10	% *	
Burnon International LTD.	*	11	%

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

The above-mentioned customers are distributors of the Company's products. No other customers accounted for 10% or more of the Company's accounts receivable on these dates.

## International Sales

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

	Three Months Ended March 31,		
	2015	2014	
Hong Kong/China	47	% 44	%
Taiwan	13	% 16	%
Korea	12	% 11	%
Western Europe (excluding Germany)	12	% 11	%
Japan	5	% 6	%
Singapore	1	% 2	%
Germany	2	% 2	%
Other	4	% 3	%
Total foreign revenue	96	% 95	%

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

## Product Sales

Net revenues consist primarily of sales of the Company's high-voltage integrated-circuit products, IGBT drivers and high-voltage silicon diodes. When evaluating the Company's net revenues, the Company categorizes its sales into the following four end-market groupings: communications, computer, consumer and industrial. The table below provides the percentage of net sales activity by end market for the three months ended March 31, 2015 and 2014: