POWER INTEGRATIONS INC
Form 10-Q
November 09, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)
[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2001

or

[_] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ______________ to ______________

Commission File Number 0-23441

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

DELAWARE	94-3065014
(State or other jurisdiction of 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)

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

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

Class	Outstanding at October 31, 2001
Common Stock, $.001 par value	27,928,951 shares

POWER INTEGRATIONS, INC.

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SIGNATURES

TOPSwitch, TinySwitch and EcoSmart are trademarks of Power Integrations, Inc.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

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ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 42
Short-term investments	24
Accounts receivable	9
Inventories	24
Deferred tax assets	6
Prepaid expenses and other current assets	1
Total current assets	108
PROPERTY AND EQUIPMENT, net	24
	$133
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Current portion of capitalized lease obligations	$
Accounts payable	6
Accrued payroll and related expenses	3
Taxes payable and other accrued liabilities	1
Deferred income on sales to distributors	1
Total current liabilities	13
LONG TERM LIABILITIES:	
Capitalized lease obligations, net of current portion	
Deferred rent	
Total long term liabilities	
STOCKHOLDERS' EQUITY:	
Common stock	
Additional paid-in capital	79
Stockholder notes receivable	
Deferred compensation	
Cumulative translation adjustment	
Retained earnings	40
Total stockholders' equity	119
	$133

The accompanying notes are an integral part of these condensed consolidated balance sheets.

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		N
	2001	2000	2
NET REVENUES:			
Product sales	$ 22,710	$ 27,377	$
License fees and royalties	293	483	
Total net revenues	23,003	27,860	
COST OF REVENUES	13,092	13,280	
GROSS PROFIT	9,911	14,580	
OPERATING EXPENSES:			
Research and development	3,586	3,084	
Sales and marketing	3,797	3,139	
General and administrative	1,537	1,743	
Total operating expenses	8,920	7,966	
INCOME FROM OPERATIONS	991	6,614	
OTHER INCOME, net	325	701	
INCOME BEFORE PROVISION FOR INCOME TAXES	1,316	7,315	
PROVISION FOR INCOME TAXES	395	2,219	
NET INCOME	$ 921	$ 5,096	$
EARNINGS PER SHARE:			
Basic	$ 0.03	$ 0.19	$
Diluted	$ 0.03	$ 0.18	$
SHARES USED IN PER SHARE CALCULATION:			
Basic	27,758	27,325	
Diluted	29,339	28,495	

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

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(In thousands)

	Nine Months Ende
	2001
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$ 5,463
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	4,873
Deferred compensation expense	41
Deferred rent	349
Provision for accounts receivable and other allowances	229
Change in operating assets and liabilities:	
Accounts receivable	(318)
Inventories	(2,743)
Prepaid expenses and other current assets	2,654
Accounts payable	(1,235)
Accrued liabilities	(1,351)
Deferred income on sales to distributors	(768)
Net cash provided by operating activities	7,194
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of property and equipment	(6,931)
Purchases of short-term investments	(24,750)
Proceeds from sales and maturities of short-term investments	27,303
Net cash provided by (used in) investing activities	(4,378)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Net proceeds from issuance of common stock	3,773
Proceeds from stockholder note repayment	38
Principal payments under capitalized lease obligations	(505)
Net cash provided by financing activities	3,306
NET INCREASE IN CASH AND CASH EQUIVALENTS	6,122
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	36,462
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 42,584
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:	
Cash paid for interest	$ 53
Cash paid for income taxes	$ 3,849

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

POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION:

The condensed consolidated financial statements include the accounts of Power Integrations, Inc. (the Company), a Delaware corporation, and its wholly owned subsidiaries. Significant inter-company accounts and transactions have been eliminated.

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) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. 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 for the year ended December 31, 2000 included in its Form 10-K.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Cash and Cash Equivalents and Short-Term Investments

The Company considers cash invested in highly liquid financial instruments with an original maturity of three months or less to be cash equivalents. Cash investments in highly liquid financial instruments with original maturities greater than three months but not longer than fifteen months are classified as short-term investments. As of September 30, 2001, the Company's short-term investments consisted of U.S. government backed securities, corporate commercial paper and other high quality commercial and municipal securities, which were classified as held to maturity and were valued using the amortized cost method which approximates market.

Revenue Recognition

Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. Revenues from product sales to OEMs and merchant power supply manufacturers are recognized upon shipment. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company's products held by the distributors. As a result of the Company's distributor agreements, the Company defers recognition of revenue and the proportionate costs of revenues derived from sales to distributors until the distributors resell the Company's products to their customers. The margin deferred as a result of this policy is reflected as "deferred income on sales to distributors" in the accompanying condensed consolidated balance sheets.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

Segment Reporting

During 1998, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No.131 requires a new basis of determining reportable business segments, i.e., the management approach. This approach requires that business segment information used by management to assess performance and manage company resources be the source for information disclosure. On this basis, the Company is organized and operates as one business segment, that being the design, development, manufacture and marketing of proprietary, high-voltage, analog integrated circuits for use in power conversion markets.

Recent Accounting Pronouncements

In June 1999, the Financial Accounting Standards Board issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133," which amends SFAS No. 133 to be effective for all fiscal years beginning after June 15, 2000. In June 2000, SFAS No. 133 was amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," which amended or modified certain issues discussed in SFAS No. 133. SFAS No. 138 is also effective for all fiscal years beginning after June 15, 2000. SFAS No. 133 and SFAS No. 138 establish accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or liability measured at its fair value. The statements also require that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. The Company does not engage in derivative instruments or hedging activities. Accordingly, there was no impact on the Company's financial statements from the adoption of SFAS No. 133 and SFAS No. 138 in the first quarter of 2001.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 provides guidance on applying generally accepted accounting principles to revenue recognition issues in financial statements. The Company has reviewed its revenue recognition policies and determined that they are in compliance with SAB 101. Accordingly, there was no impact on the Company's financial statements from adopting SAB 101 in the fourth quarter of 2000.

In July 2001, the Financial Accounting Standards Board issued SFAS No.'s 141 and 142, "Business Combinations" and "Goodwill and Other Intangibles", respectively. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS No. 142,

effective January 1, 2002, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill is subject to at least an annual assessment for impairment, applying a fair-value based test. Additionally, an acquired intangible asset should be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. The Company does not expect the adoption of SFAS No. 141 and SFAS No. 142 to have a material impact on its financial statements.

In August 2001, the Financial Accounting Standards Board issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the long-lived assets to be held and used, and disposed of. The statement will be effective for financial statements issued for fiscal years beginning after December 15, 2001. The Company does not expect the adoption of SFAS No. 144 to have a material impact on its financial statements.

3. INVENTORIES:

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following (in thousands):

	September 30, 2001
Raw materials	$ 1,542
Work-in-process	13,740
Finished goods	9,060
	$24,342

POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

4. SIGNIFICANT CUSTOMERS AND EXPORT SALES:

Customer Concentration

The Company's end user base is highly concentrated and a relatively small number of OEMs and distributors accounted for a significant portion of the Company's net revenues. Ten customers accounted for approximately 77.4% and 67.7% of total net revenues for the three months ended September 30, 2001 and 2000, respectively, and approximately 73.1% and 68.9% of total net revenues for the nine months ended September 30, 2001 and 2000, respectively.

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

Customer	Three Months Ended September 30, 2001	Three Months Ended September 30, 2000	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
A	19.0%	21.3%	22.8%	21.1%
B	16.3%	*	12.2%	*
C	14.5%	*	*	*

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*   less than 10% or no sales

Customers A & B are distributors of the company's products and customer C is a merchant power supply manufacturer who in turn sells its manufactured power supplies to third party customers.

Export Sales

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

	Three Months Ended September 30, 2001	Three Months Ended September 30, 2000	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
Taiwan	35.4%	21.3%	28.9%	21.7%
Hong Kong/China	24.0%	24.3%	27.9%	22.6%
Western Europe	16.6%	18.0%	17.9%	18.5%
Korea	9.0%	7.9%	9.1%	10.6%
Singapore	5.7%	--	4.3%	--
Japan	1.2%	3.0%	1.7%	2.5%
Thailand	1.0%	1.9%	1.0%	2.7%
Other	1.6%	4.3%	1.6%	3.7%
Total foreign	94.5%	80.7%	92.4%	82.3%

Product Sales

Sales of our TOPSwitch products accounted for 99.5% and 97.7% of net revenues from product sales for the three months ended September 30, 2001 and 2000, respectively, and 98.3 % and 97.7% of net revenues from product sales for the nine months ended September 30, 2001 and 2000, respectively. TOPSwitch products include TOPSwitch, TOPSwitch II, TOPSwitch FX, TopSwitch GX, TinySwitch and TinySwitch II.

POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

5. EARNINGS PER SHARE:

Earnings per share are calculated in accordance with SFAS No. 128, "Earnings per Share." SFAS No. 128 requires companies to compute earnings per share under two different methods (basic and diluted). 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 outstanding common stock and common stock equivalents during the period. Common stock equivalents included in the diluted calculation consist of dilutive shares issuable upon the exercise of outstanding common stock options and shares issuable under the employee stock purchase plan using the treasury stock method.

The following table sets forth the calculation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three Months Ended September 30,		
	2001	2000	
Basic earnings per share:			
Net income	$ 921	$ 5,096	$
Weighted average common shares	27,758	27,325	2
Basic earnings per share	$ 0.03	$ 0.19	$
Diluted earnings per share:			
Net income	$ 921	$ 5,096	$
Weighted average common shares	27,758	27,325	2
Weighted average common share equivalents:			
Options	1,569	1,168	
Employee stock purchase plan	12	2	
Diluted weighted average common shares	29,339	28,495	2
Diluted earnings per share	$ 0.03	$ 0.18	$

6. PROVISION FOR INCOME TAXES:

Income tax expense for the nine-month periods ended September 30, 2001 and 2000 includes a provision for Federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries for the year. The difference between the statutory rate and the Company's effective tax rate for the nine months ended September 30, 2001 and 2000 is primarily due to the beneficial impact of international sales, research and development credits and Federal tax-exempt investments.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations includes a number of forward-looking statements, which reflect our current views with respect to future events and financial performance. In this report, the words "anticipates," "believes," "expects," "future," "intends," "should," "will" and similar expressions identify forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties, including those discussed in the "Factors That May Affect Future Results of Operations" and elsewhere in this report, that could cause actual results to differ materially from historical or anticipated results. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report.

The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with management's discussion and analysis of financial condition and results of operations included in our Form 10-K for the year ended December 31, 2000.

Overview

We design, develop, manufacture and market proprietary, high-voltage, analog integrated circuits, or ICs, for use primarily in AC to DC power conversion markets. We have targeted high-volume power supply markets, including the consumer, communications, computer and industrial electronics markets. Our initial focus is on those applications that are sensitive to size, portability, energy efficiency and time-to-market. We believe our patented TOPSwitch ICs, introduced in 1994, are the first highly integrated power conversion ICs to achieve widespread market acceptance. We introduced an enhanced family of ICs, TOPSwitch-II, in April 1997. In September 1998, we announced the TinySwitch family of integrated circuits for power supplies used in a broad range of electronic products. TinySwitch ICs, which are designed to reduce energy leakage by incorporating our new EcoSmart technology, enable a new class of light, compact, energy-efficient power supplies. In March 2000, we introduced the TOPSwitch-FX family of products, which also incorporates our EcoSmart technology to help engineers meet the growing need for environmentally friendly power solutions. In November 2000, we introduced the TOPSwitch-GX family of products. The GX family is capable of supplying output levels from 6 watts to 250 watts. We believe that the FX and GX families of ICs give power supply design engineers the ability to cost-effectively integrate additional functionality into the power supplies they design. In March 2001, we introduced the TinySwitch-II family of products with power levels ranging from 3 watts to 20 watts. All of our products introduced since 1998 incorporate our EcoSmart technology.

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Results of Operations

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

	Percentage of Total Net Revenues for Three Months Ended September 30,		Tota N
	2001	2000	20
Net revenues:			
Product sales	98.7%	98.3%	9
License fees and royalties	1.3	1.7	
Total net revenues	100.0	100.0	10
Cost of revenues	56.9	47.7	5
Gross profit	43.1	52.3	4
Operating expenses:			
Research and development	15.6	11.1	1
Sales and marketing	16.5	11.3	1
General and administrative	6.7	6.2	
Total operating expenses	38.8	28.6	3
Income from operations	4.3	23.7	
Other income, net	1.4	2.6	
Income before provision for income taxes	5.7	26.3	1
Provision for income taxes	1.7	8.0	
Net income	4.0%	18.3%	

Comparison of the Three and Nine Months Ended September 30, 2001 and 2000

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances, plus license fees and royalties paid by licensees of our technology. Net revenues for the quarter ended September 30, 2001 were $23.0 million compared to $27.9 million for the third quarter of 2000, a decrease of $4.9 million, or 17.4%. Net revenues for the nine months ended September 30, 2001 were $70.4 million compared to $84.9 million for the comparable period of 2000, a decrease of $14.5 million or 17.0%.

Net revenues from product sales represented $22.7 million and $27.4 million in the third quarter of 2001 and 2000, respectively. Net revenues from product sales represented $69.5 million and $83.6 million in the nine months ended September 30, 2001 and 2000, respectively. The decline in net revenues from product sales for the three months and nine months ended September 30, 2001 was generally in all of our end markets and due primarily to the unfavorable economic conditions during the period. With the results of the nine months ended September 30, 2001 and our outlook for the quarter ending December 31, 2001, we expect our full year revenue mix as a percentage of net revenues in the end markets which we serve to be approximately 33% in the consumer market category, 33% in the communications category, 20% in the computer category, 7% in the industrial category and 7% in all other. We also expect the mix of our products families for the full year to be approximately 60% for TOPSwitch I and II, 25% for TINYSwitch I and II and 15% for TOPSwitch FX and GX.

International sales were $21.7 million in the third quarter of 2001 compared to $22.5 million for the same period in 2000, a decrease of $0.8 million, or 3.6%, which represented 94.5% of net revenues compared to 80.7% in the comparable period of 2000. International sales were $65.1 million for the nine months ended September 30, 2001

compared to $69.8 million for the same period in 2000, a decrease of $4.7 million, or 6.7%, which represented 92.4% of net revenues compared to 82.3% in the comparable period of 2000. The increase in our international sales as a percentage of net revenues, for the three month and nine month periods ended September 30, 2001, was attributable primarily to a major OEM changing its sourcing of our products from North America to a merchant power supply manufacturer located in Asia. Although the power supplies using our products are designed and distributed worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region were 77.6% and 61.7% of our product sales for the three months ended September 30, 2001 and 2000, respectively, and 74.2% and 63.2% of our product sales for the nine months ended September 30, 2001 and 2000, respectively. We expect international sales to continue to account for a large portion of our net revenues.

Direct sales for the third quarter of 2001 were divided 49.0% to distributors and 51.0% to original equipment manufacturers, or OEMs, and merchant power supply manufacturers, compared to 50.1% to distributors and 49.9% to OEMs and merchant power supply manufacturers for the same quarter in 2000. For the nine months ended September 30, 2001, direct sales were divided 50.6% to distributors and 49.4% to OEMs and merchant power supply manufacturers, compared to 49.5% to distributors and 50.5 % to OEMs and merchant power supply manufacturers for the same period in 2000. For the quarter ended September 30, 2001, sales to one customer accounted for 19.0% of net revenues, and for the quarter ended September 30, 2000, that same customer accounted for 21.3% of net revenues. A second customer accounted for 16.3% of net revenues for the quarter ended September 30, 2001. For the nine month periods ended September 30, 2001 and 2000, sales to the first customer accounted for 22.8% and 21.1% of net revenues respectively, and for the nine months ended September 30, 2001, sales to the second customer accounted for 12.2% of net revenues. Both of these customers are distributors. A third customer, who is a merchant power supply manufacturer, accounted for 14.5% of net revenues for the quarter ended September 30, 2001. There were no other customers accounting for sales of more than 10% during the periods reported.

Cost of revenues; Gross profit. Gross profit is equal to net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers, the assembly and packaging of our products, and internal labor and overhead associated with the testing of both wafers and packaged components. Gross profit for the third quarter of 2001 was $9.9 million, or 43.1% of net revenues, compared to $14.6 million, or 52.3% of net revenues for the same period in 2000. Gross profit for the nine months ended September 30, 2001 was $32.7 million, or 46.4% of net revenues, compared to $44.3 million, or 52.2% of net revenues for the same period in 2000. The decrease in gross profit percentage for the three months and nine months ended September 30, 2001 was due primarily to lower sales volumes, lost manufacturing efficiencies due to new product introductions and the adverse impact of increased pressure from customers for lower pricing, partially offset by a decrease in wafer costs and assembly costs. We expect our gross margins to remain in a range of 43% to 45% over the next few quarters, but we cannot assure you that our gross profit will remain at these levels in future periods.

Research and development expenses. Research and development expenses consist primarily of employee-related expenses, expensed material and facility costs associated with the development of new processes and new products. We also expense prototype wafers and mask sets related to new products as research and development costs until new products are released to production. Research and development expenses for the third quarter of 2001 were $3.6 million compared to $3.1 million for the same period in 2000, an increase of $0.5 million, or 16.3%, which represented 15.6% and 11.1% of our net revenues in each period, respectively. Research and development expenses for the first nine months of 2001 were $10.8 million compared to $9.6 million for the same period in 2000, an increase of $1.2 million, or 13.2%, which represented 15.4% and 11.3% of net revenues in each period, respectively. The increase for the three months and nine months ended September 30, 2001 was due primarily to increased salaries and other costs related to the hiring of additional engineering personnel, outside consulting fees and higher facility costs. We expect research and development expenses to continue to increase in absolute dollars but to fluctuate as a percentage of our net revenues.

Sales and marketing expenses. Sales and marketing expenses consist primarily of employee-related expenses, commissions to sales representatives and facilities expenses, including expenses associated with our regional sales offices and applications engineering. Sales and marketing expenses for the third quarter of 2001 were $3.8 million compared to $3.1 million for the same period in 2000, an increase of $0.7 million, or 21.0%, which represented 16.5% and 11.3% of our net revenues in each period, respectively. Sales and marketing expenses for the first nine months of 2001 were $11.1 million compared to $10.0 million for the same period in 2000, an increase of $1.1 million, or 11.6%, which represented 15.8% and 11.7% of our net revenues in each period, respectively. The increase for the three months and nine months ended September 30, 2001 resulted primarily from the addition of

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personnel to support our sales effort and the increased activity in application engineering. Included in the above marketing expenses are costs associated with applications engineering representing $1.0 million and $0.6 million for the three months ended September 30, 2001 and 2000, respectively, and $2.8 million and $2.1 million for the nine months ended September 30, 2001 and 2000, respectively. We expect sales and marketing expenses to continue to increase in absolute dollars but to fluctuate as a percentage of our net revenues.

General and administrative expenses. General and administrative expenses consist primarily of employee-related expenses for administration, finance, human resources and general management, as well as consulting, outside services, legal and auditing expenses. For the quarters ended September 30, 2001 and 2000, general and administrative expenses were $1.5 million and $1.7 million, respectively, which represented 6.7% and 6.2% of our net revenues in each period. For the nine months ended September 30, 2001 and 2000, general and administrative expenses were $4.3 million and $5.2 million, respectively, which represented 6.1% of our net revenues in both periods. The decrease in spending, for the comparable nine month periods, was attributable primarily to a reduction in professional and legal expenses following the settlement last year of our patent infringement lawsuit, which we initiated with Motorola. We expect general and administrative expenses to increase in absolute dollars, but to fluctuate as a percentage of our net revenues.

Other income, net. Other income, net, for the third quarter of 2001 decreased by $0.4 million compared to the same period in 2000, and for the nine months ended September 30, 2001, decreased by $0.7 million compared to the same

period in 2000. The decrease for each of the three and nine month periods ended September 30, 2001 was due primarily to lower interest rates on our cash equivalents and short-term investments in 2001 compared to 2000, and an increase in costs attributable to foreign currency fluctuations.

Provision for income taxes. Provision for income taxes represents Federal, state and foreign taxes. The provision for income taxes was $0.4 million for the third quarter of 2001 compared to $2.2 million for the same period in 2000. The provision for income taxes was $2.4 million for the first nine months of 2001 compared to $6.5 million for the same period in 2000. Our estimated effective tax rate used for both 2001 and 2000 was 30%. The difference between the statutory rate and our effective tax rate for both years is due primarily to the beneficial impact of international sales, research and development credits and Federal tax-exempt investments.

Liquidity and Capital Resources

At September 30, 2001, we had approximately $67.0 million in cash, cash equivalents and short-term investments. In addition, under a revolving line of credit with Union Bank of California, we can borrow up to $10.0 million. A portion of the credit line is used to cover advances for commercial letters of credit and standby letters of credit, which we provide to Matsushita and OKI prior to the shipment of wafers by these foundries to us. The balance of this credit line is unused and available. The line of credit agreement, which expires on July 1, 2002, contains financial covenants requiring that we maintain profitability on a quarterly basis and not pay or declare dividends without the bank's prior consent. We have financed a significant portion of our machinery and equipment through capital equipment leases. There was no additional equipment financing during the nine months ended September 30, 2001.

As of September 30, 2001, we had working capital, defined as current assets less current liabilities, of approximately $95.5 million, an increase of approximately $8.5 million from December 31, 2000. Our operating activities generated cash of $7.2 million and $6.0 million in the nine months ended September 30, 2001 and 2000, respectively. Cash generated in the first nine months of 2001 was principally the result of net income in the amount of $5.5 million, depreciation and amortization, and a decrease in prepaid expenses, partially offset by an increase in inventory and a decrease in accounts payable and accrued liabilities. Cash generated in the first nine months of 2000 was principally the result of net income in the amount of $15.2 million, depreciation and amortization, and an increase in accrued liabilities, partially offset by an increase in inventory and a decrease in accounts payable.

Our investing activities were a net transfer to cash and cash equivalents from short-term investments of $2.6 million in the nine months ended September 30, 2001, and a net transfer from short-term investments to cash and cash equivalents of $13.2 million in the nine months ended September 30, 2000. Purchases of property and equipment were $6.9 million and $10.8 million in the nine months ended September 30, 2001 and 2000, respectively.

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.

Recent Accounting Pronouncements

In June 1999, the Financial Accounting Standards Board issued SFAS No. 137,

"Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133," which amends SFAS No. 133 to be effective for all fiscal years beginning after June 15, 2000. In June 2000, SFAS No. 133 was amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," which amended or modified certain issues discussed in SFAS No. 133. SFAS No. 138 is also effective for all fiscal years beginning after June 15, 2000. SFAS No. 133 and SFAS No. 138 establish accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or liability measured at its fair value. The statements also require that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. We do not engage in derivative instruments or hedging activities. Accordingly, there was no impact on our financial statements from the adoption of SFAS No. 133 and SFAS No. 138 in the first quarter of 2001.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 provides guidance on applying generally accepted accounting principles to revenue recognition issues in financial statements. We have reviewed our revenue recognition policies and determined that they are in compliance with SAB 101. Accordingly, there was no impact on our financial statements from adopting SAB 101 in the fourth quarter of 2000.

In July 2001, the Financial Accounting Standards Board issued SFAS No.'s 141 and 142, "Business Combinations" and "Goodwill and Other Intangibles", respectively. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS No. 142, effective January 1, 2002, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill is subject to at least an annual assessment for impairment, applying a fair-value based test. Additionally, an acquired intangible asset should be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. We do not expect the adoption of SFAS No. 141 and SFAS No. 142 to have a material impact on our financial statements.

In August 2001, the Financial Accounting Standards Board issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the long-lived assets to be held and used, and disposed of. The statement will be effective for financial statements issued for fiscal years beginning after December 15, 2001. We do not expect the adoption of SFAS No. 144 to have a material impact on our financial statements.

Factors That May Affect Future Results of Operations

In addition to the other information in this report, the following factors should be considered carefully in evaluating our business before purchasing shares of our stock.

Our quarterly operating results are volatile and difficult to predict. If we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly. Our net revenues and operating results have varied significantly in the past, are difficult to forecast, are subject to numerous factors both within and outside of our control, and may fluctuate significantly in the future. As a result, our quarterly operating results could fall below the expectations of public market analysts or investors. If that occurs, the price of our stock may decline.

Some of the factors that could affect our operating results include the following:

- the volume and timing of orders received from customers;

- the volume and timing of orders placed by us with our foundries;

- changes in product mix including the impact of new product introduction on existing products;

- our ability to develop and bring to market new products and technologies on a timely basis;

- the timing of investments in research and development and sales and marketing;

- cyclical semiconductor industry conditions; and

- fluctuations in exchange rates, particularly the exchange rates between the U.S. dollar and the Japanese yen.

We do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and business may suffer. Our business is characterized by short-term customer orders and shipment schedules. The ordering patterns of some of our existing large customers have been unpredictable in the past, and we expect that customer-ordering patterns will continue to be unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without penalty to them. In the past we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time.

Intense competition in the high-voltage power supply industry may lead to a decrease in the average selling price and reduced sales volume of our products, which may harm our business. The high-voltage power supply industry is intensely competitive and characterized by significant price erosion. Our products face competition from alternative technologies, including traditional linear transformers and discrete switcher power supplies. If the price of competing products decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized, including battery chargers for cellular telephones, drop below current power levels, these older alternative technologies can be used more cost effectively than our TOPSwitch-based switchers.

We cannot assure you that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market. We believe our failure to compete successfully in the high-voltage power supply business, including our ability to introduce new products with higher average selling prices, would materially harm our operating results.

If demand for our products declines in the major end markets that we serve, our net revenues will decrease. Applications of our products in the consumer, communications and computer end markets, such as cellular phone chargers,

stand-by power supplies for PCs and main power supplies for TV set top boxes have and will continue to account for a large percentage of our net revenues. We expect that a significant level of our net revenues and operating results will continue to be dependent upon these applications in the near term. The demand for these products has been highly cyclical and has been subject to significant economic downturns at various times. The recent announcements of economic slowdown by major companies in some of the end markets we serve, indirectly through our customers, have caused a slowdown in demand for some of our ICs. When our customers are not successful in maintaining high levels of demand for their products, their demand for our ICs decreases, which adversely affects our operating results. This decline in demand contributed to a decline in our net revenues during the three month and nine month periods ended September 30, 2001. Any significant downturn in demand in these markets would cause our net revenues to decline and could cause the price of our stock to fall.

Because the sales cycle for our products can be lengthy, we may incur substantial expenses before we generate significant revenues, if any. Our products are generally incorporated into a customer's products at the design stage. However, customer decisions to use our products, commonly referred to as design wins, which can often require us to expend significant research and development and sales and marketing resources without any assurance of success, often precede volume sales, if any, by a year or more. The value of any design win will largely depend upon the

commercial success of the customer's product. We cannot assure you that we will continue to achieve design wins or that any design win will result in future revenues. If a customer decides at the design stage not to incorporate our products into its product, we may not have another opportunity for a design win with respect to that product for many months or years.

Our products must meet exacting specifications, and undetected defects and failures may occur which could cause customers to return or stop buying our products. Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. ICs as complex as those we sell often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments. We have from time to time in the past experienced product quality, performance or reliability problems. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments and product returns or discounts, any of which would harm our operating results.

We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient wafers, our business will suffer. We have supply arrangements for the production of wafers with Matsushita and OKI. Although certain aspects of our relationships with Matsushita and OKI are contractual, many important aspects of these relationships depend on their continued cooperation and, in many instances, their course of conduct deviates from the literal provisions of the contracts. We cannot assure you that we will continue to work successfully with Matsushita or OKI in the future, that they will continue to provide us with sufficient capacity at their foundries to meet our needs, or that either of them will not seek an early termination of its wafer supply agreement with us. We estimate that it would take 9 to 12 months from the time we identified an alternate manufacturing source before that source could produce wafers with acceptable manufacturing yields in sufficient quantities to meet our needs.

Although we provide Matsushita and OKI with rolling forecasts of our production requirements, their ability to produce wafers for us is limited by the available capacities of the foundries in which these wafers are manufactured. An increased need for capacity to meet internal demands or demands of other customers could cause Matsushita and OKI to reduce capacity available to us. Matsushita and OKI may also require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions in order to acquire the wafer supply necessary to meet our customers' requirements. Any of these concessions could harm our business.

If our third-party suppliers and independent subcontractors do not produce our wafers and assemble our finished products at acceptable yields, our net revenues may decline. We depend on Matsushita and OKI to produce wafers, and independent subcontractors to assemble finished products, at acceptable yields and to deliver them to us in a timely manner. The failure of Matsushita or OKI to supply us wafers at acceptable yields could prevent us from selling our products to our customers and would likely cause a decline in our net revenues. In addition, our IC assembly process requires our manufacturers to use a high-voltage molding compound, which is available from only one vendor, and which is difficult to process. This compound and its required processes, together with the other non-standard materials and processes needed to assemble our products, require a more exacting level of process control than normally required for standard packages. Unavailability of the sole source compound or problems with the assembly process can materially adversely affect yields and cost to manufacture. We cannot assure you that acceptable yields will be maintainable in the future.

Matsushita has licenses to our technology, which it may use to our detriment. Our ability to take advantage of the Japanese market for our products is primarily dependent on Matsushita and its ability to promote and deliver our products. Pursuant to our agreement with Matsushita, Matsushita has the right to manufacture and sell products using our technology to Japanese companies worldwide and to subsidiaries of Japanese companies located in Asia. Although we receive royalties on Matsushita's sales, these royalties are substantially lower than the gross profit we would receive on direct sales. We cannot assure you that Matsushita will not use the technology rights we have granted it to develop or market competing products following any termination of its relationship with us or after termination of Matsushita's royalty obligation to us.

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Our international sales activities subject us to substantial risks. Sales to customers outside of the United States account for a large portion of our net revenues. These sales involve a number of risks to us, including:

- potential insolvency of international distributors and representatives;
- reduced protection for intellectual property rights in some countries;
- the impact of recessionary environments in economies outside the United States;
- tariffs and other trade barriers and restrictions; and
- the burdens of complying with a variety of foreign laws.

Our failure to adequately address these risks could reduce our international sales, which would materially adversely affect our operating

results. Furthermore, because substantially all of our foreign sales are denominated in U.S. dollars, increases in the value of the dollar increase the price in local currencies of our products in foreign markets and make our products relatively more expensive and less price competitive than competitors' products that are priced in local currencies.

If our efforts to enhance existing products and introduce new products are not successful, we may not be able to generate demand for our products. Our success depends in significant part upon our ability to develop new ICs for high-voltage power conversion for existing and new markets, to introduce these products in a timely manner and to have these products selected for design into products of leading manufacturers. New product introduction schedules are subject to the risks and uncertainties that typically accompany development and delivery of complex technologies to the market place, including product development delays and defects. If we fail to develop and sell new products in a timely manner, our net revenues could decline.

We cannot be sure that we will be able to adjust to changing market demands as quickly and cost-effectively as necessary to compete successfully. Furthermore, we cannot assure you that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Our failure, or our customers' failure to develop and introduce new products successfully and in a timely manner would harm our business and may cause the price of our common stock to fall. In addition, customers may defer or return orders for existing products in response to the introduction of new products. Although we maintain reserves against returns, we cannot assure you that these reserves will be adequate.

We rely on a continuous power supply to conduct operations, and California's current energy crisis could disrupt our business and increase our expenses. California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage, that is, when power reserves for California fall below 1.5%, California has on some occasions implemented, and may in the future continue to implement, rolling blackouts throughout California. Most of our operations are located in California. We currently have only limited backup generators for emergency alternate sources of power in the event of a blackout. If blackouts interrupt our power supply, we would be temporarily unable to continue operations at our facilities. Any such interruption in our ability to continue operations at our facilities could delay shipments of our products to customers, and could result in lost revenue, which could harm our business and results of operations.

If our products do not penetrate additional markets, our business will not grow as we predict. We believe that our future success depends in part upon our ability to penetrate additional markets for our products. We cannot assure you that we will be able to overcome the marketing or technological challenges necessary to do so. To the extent that a competitor penetrates additional markets before we do, or takes market share from us in our existing markets, our net revenues and financial condition could be materially adversely affected.

In the event of an earthquake, terrorist act or other disaster, our operations may be interrupted and our business would be harmed. Our principal executive offices and operating facilities are located near San Francisco, California. This area has been subject to severe earthquakes. In the event of an earthquake, we may be temporarily

unable to continue operations at our facilities and we may suffer significant property damage. Any such interruption in our ability to continue operations at our facilities could delay the development and shipment of our products.

Like other U.S. companies, our business and operating results are subject to uncertainties arising out of the recent terrorist attacks on the United States, including the potential worsening or extension of the current global economic slowdown, the economic consequences of military actions or additional terrorist activities and associated political instability, and the impact of heightened security concerns on domestic and international travel and commerce. Such uncertainties could also lead to delays or cancellations of customer orders, a general decrease in corporate spending or our inability to effectively market and sell our products. Any of these results could substantially harm our business and results of operations, causing a decrease in our revenues.

If we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses or lose valuable assets. Our success depends upon our ability to protect our intellectual property, including patents, trade secrets, and know-how, and to continue our technological innovation. We cannot assure you that the steps we have taken to protect our intellectual property will be adequate to prevent misappropriation or that others will not develop competitive technologies or products. From time to time we have received, and we may receive in the future, communications alleging possible infringement of patents or other intellectual property rights of others. Litigation, which could result in substantial cost to us, may be necessary to enforce our patents or other intellectual property rights or to defend us against claimed infringement of the rights of others. The failure to obtain necessary licenses or other rights or litigation arising out of infringement claims could cause us to lose market share and harm our business.

Moreover, the laws of some foreign countries in which our technology is or may in the future be licensed may not protect our intellectual property rights to the same extent as the laws of the United States, thus increasing the possibility of infringement of our intellectual property.

We must attract and retain qualified personnel to be successful and competition for qualified personnel is intense in our market. Our success depends to a significant extent upon the continued service of our executive officers and other key management and technical personnel. The competition for these employees is intense, particularly in Silicon Valley. The loss of the services of one or more of our engineers, executive officers or other key personnel or our inability to recruit replacements for these individuals or to otherwise attract, retain and motivate qualified personnel could harm our business. We have neither long-term employment contracts with, nor key person life insurance policies on, any of our employees.

We have adopted anti-takeover measures, which may make it more difficult for a third party to acquire us. We have adopted a preferred stock purchase rights plan that is intended to guard against hostile takeover tactics. The adoption of this plan was not in response to any proposal to acquire us, and the board is not aware of any such effort. Our board of directors has the authority to issue up to 3,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of shares of preferred stock, while potentially providing flexibility in connection with possible acquisitions and for other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. We have no present intention to issue shares of preferred stock.

The future trading price of our common stock could be subject to wide fluctuations in response to a variety of factors. The price of our common stock has been, and is likely to be, volatile. Factors including future announcements concerning us or our competitors, quarterly variations in operating results, announcements of technological innovations, the introduction of new products or changes in our product pricing policies or those of our competitors, proprietary rights or other litigation, changes in earnings estimates by analysts and other factors could cause the market price of our common stock to fluctuate substantially. In addition, stock prices for many technology companies fluctuate widely for reasons, which may be unrelated to operating results. These fluctuations, as well as general economic, market and political conditions, may harm the market price of our common stock.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS.

There has not been a material change in our exposure to interest rate and foreign currency risks since the date of our 2000 Annual Report on Form 10-K.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. 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 ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

The table below presents principal amounts and related weighted average interest rates for our investment portfolio at September 30, 2001. All investments mature, by policy, in 15 months or less.

(in thousands, except average interest rates)

	Carrying Amount	Average Interest Rate
Cash Equivalents:		
Tax-exempt securities	$ 33,450	2.48%
Total cash equivalents	33,450	2.48%
Short-term Investments:		
U.S. corporate securities	6,500	4.31%
U.S. government securities	6,000	4.68%
Tax-exempt securities	11,250	3.70%
Total short-term investments	23,750	4.23%

Total investment securities	$ 57,200	3.79%
	=========	==========

Foreign Currency Exchange Risk. We transact business in various foreign countries. Our primary foreign currency cash flows are in Asia and Western Europe. Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts as the foreign currency transactions and risks to date have not been significant. We do maintain a Japanese yen account with a U. S. Bank for payments to suppliers and for cash receipts from Japanese suppliers and customers denominated in Japanese yen.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits.

The following exhibit is attached hereto and filed herewith:

4.3 Amendment to Rights Agreement between Bank Boston, N.A. and Power Integrations, Inc. dated February 24, 1999, effective as of October 9, 2001.

b. Reports on Form 8-K.

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities

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

POWER INTEGRATIONS, INC.

Dated: November 9, 2001

By: /s/ JOHN M. COBB

John M. Cobb
Chief Financial Officer