innovation in POWER conversion

POWER INTEGRATIONS

1999 Annual Report

POWI

the market leader in

1999 was another excellent year for Power Integrations. Net revenue was up 49 percent over last year to $104.1 million and net income increased 93 percent to $24.5 million. We continued to strengthen our balance sheet, especially cash which grew $17.3 million to end the year at $61.7 million.

Our revenue grew at a faster rate than that of the markets we serve, primarily because we gained share in the rapidly expanding cellular phone market. We are pleased to have increased our revenue in cell phones, the world's largest electronics market, by approximately 128 percent. Our top priority is to be the dominant power conversion IC solution for all cellular phones and other emerging wireless communication devices.

In 1999, our solutions were increasingly adopted in the standby power supply market — initially in desktop PCs and now in televisions. Our revenue growth in this market was fueled by manufacturers shifting to "greener" products. We introduced *EcoSmart*™ technology in our *TinySwitch*™ product line to meet this growing need for energy efficiency. Our *TinySwitch* product line, based on our new energy-saving *EcoSmart* technology, won Discover Magazine's prestigious 1999 Award for Technological Innovation in the Environment category.

Another focus market was TV set-top boxes, where revenue increased by more than 300 percent over 1998. Although smaller than our other key markets, it is growing rapidly with applications that require higher power, higher average selling price chips.

In October of 1999, a jury ruled in our favor in the patent infringement lawsuit we initiated against Motorola. Subsequent to the jury verdict, we entered into a settlement with Motorola and the court then issued a permanent injunction prohibiting Motorola from selling ICs that were the subject of the lawsuit. Additionally, Power Integrations will remain a preferred supplier of high-voltage ICs and will work more closely with Motorola to develop their next generation of cell phone chargers. Although this settlement will not have any favorable impact on our financial performance in the near term, we believe it paves the way for us to achieve long-term revenue expansion with Motorola.

In 1999, we continued to make significant investments in people, systems, capacity and, of course, the development of new technology and products. Every year I feel more confident that the market forces favoring smaller, better and "greener" electronic products will ultimately compel manufacturers to give consumers what they want: power supplies better suited to the portable and energy efficient products at the center of this new generation of electronics. We are ready for this transition — and for the accelerated use of highly integrated power supplies enabled by our superior IC solutions.

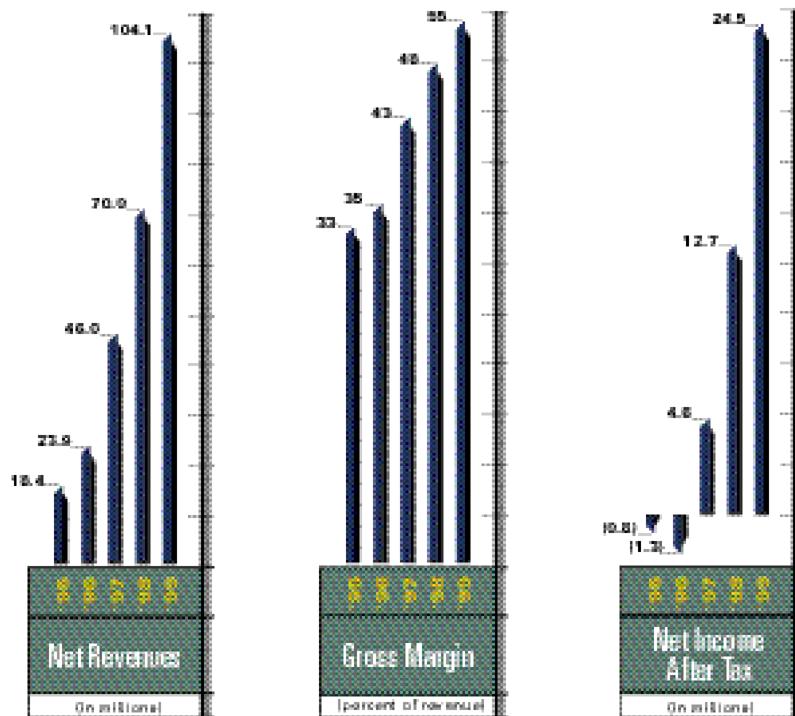
Thank you for your continued support.

Howard F. Earhart

President and CEO, Power Integrations, Inc.

POWER conversion

1999 FINANCIAL HIGHLIGHTS



As the leader in high-voltage integrated circuits (ICs) for power conversion, Power Integrations is answering the power needs of today and tomorrow's high-volume electronics. Our ICs enable highly integrated power supplies that are smaller, lighter, greener and therefore a far better match for today's major trends in electronics: portability, wireless connectivity and energy efficiency.

the best solution for

To operate, all electronic products need high-voltage AC power from a wall socket to be converted to low-voltage DC power. Unlike power conversion products of the past, Power Integrations is applying patented silicon technology that enables power supplies to be lighter, greener, better and cheaper.

Proven Superior Solution

- 350 million PI ICs have been used in a wide variety of markets since 1994.

Market Leader in Integrated Power Supplies

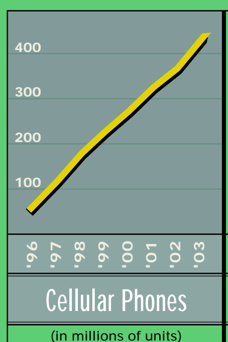
- Approximately 90 percent of the products with "highly integrated" power supplies used our ICs last year.

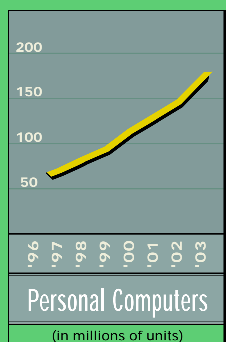
Accelerating Penetration of Key Markets

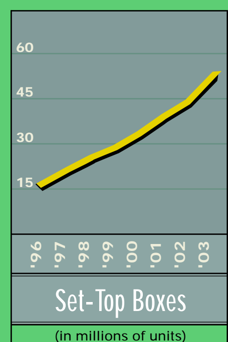
In 1999, we supplied ICs to approximately

- 25 percent of all cell phone chargers, the world's largest electronics market.
- 35 percent of the emerging market for PC stand-by power supplies, due to the growing worldwide demand for greater energy efficiency.
- 45 percent of the rapidly growing TV set-top box market.

Projected Growth of Key Markets





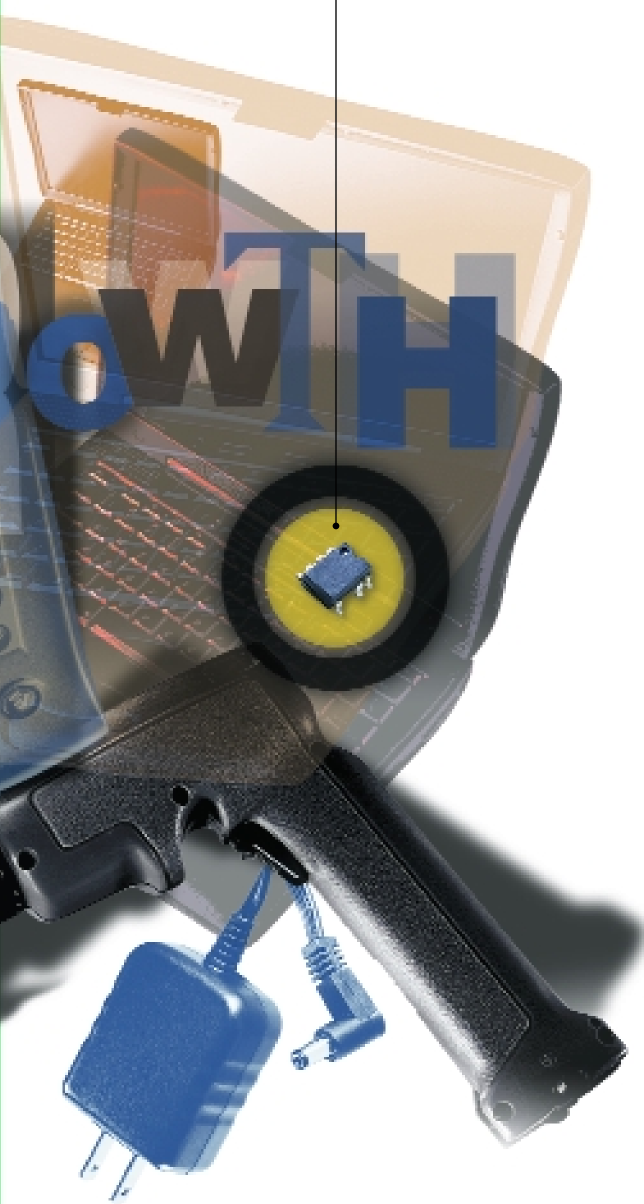


Source: Dataquest

We will continue to target these key markets, particularly the largest and rapidly expanding wireless communications sector. We are also continuing to look for ways to convert other large and growing markets, including printers, computer peripherals and home appliances, to our integrated solution.

POWER hungry markets

FAVORABLE MARKET FORCES



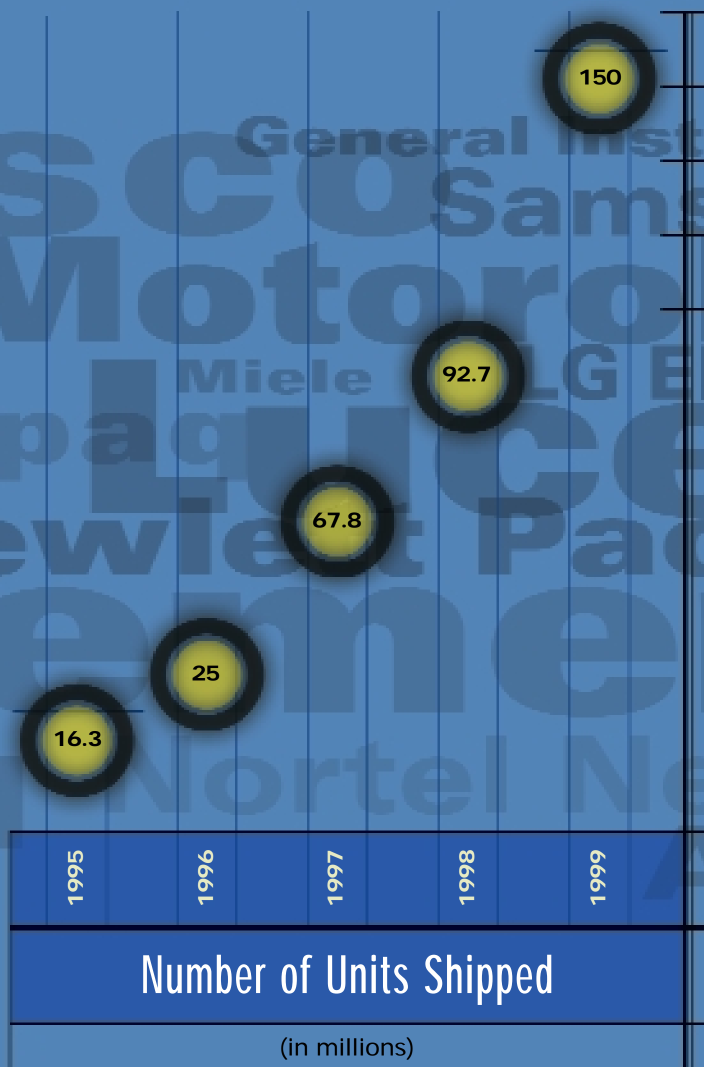
As global trends move toward portability, wireless connectivity and responsible use of energy, so do the opportunities that favor our solutions.

A communications revolution is causing an explosion in two major growth sectors — wireless technology and the Internet. Whether the next-generation cell phone operates like a personal computer, an internet browser or a personal video conference system, consumers will embrace the latest lightweight hand-held devices, but are not likely to accept the brick-like chargers that have historically accompanied many of them. Our ICs enable smaller and lighter weight power supplies to meet the portable power needs of customers in an increasingly wireless world.

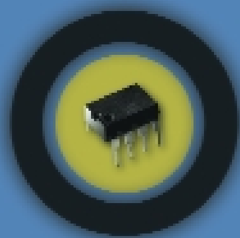
As the use of electronic products expands globally, the need for energy efficiency grows. Trends already dictate a more responsible use of power. Governments around the world are setting stricter energy efficiency guidelines for electronic products, including "Energy Star" in the U.S. and similar programs in Europe and Asia. In response, leading manufacturers have voluntarily begun to design "greener" products, making markets more receptive than ever to the energy-friendly solutions enabled by our ICs.

Our goal is to maintain our market leadership in supplying the most effective and efficient power conversion solutions to this expanding world of electronic products.

a global



Market leaders around the world use our ICs to power their leading-edge products.



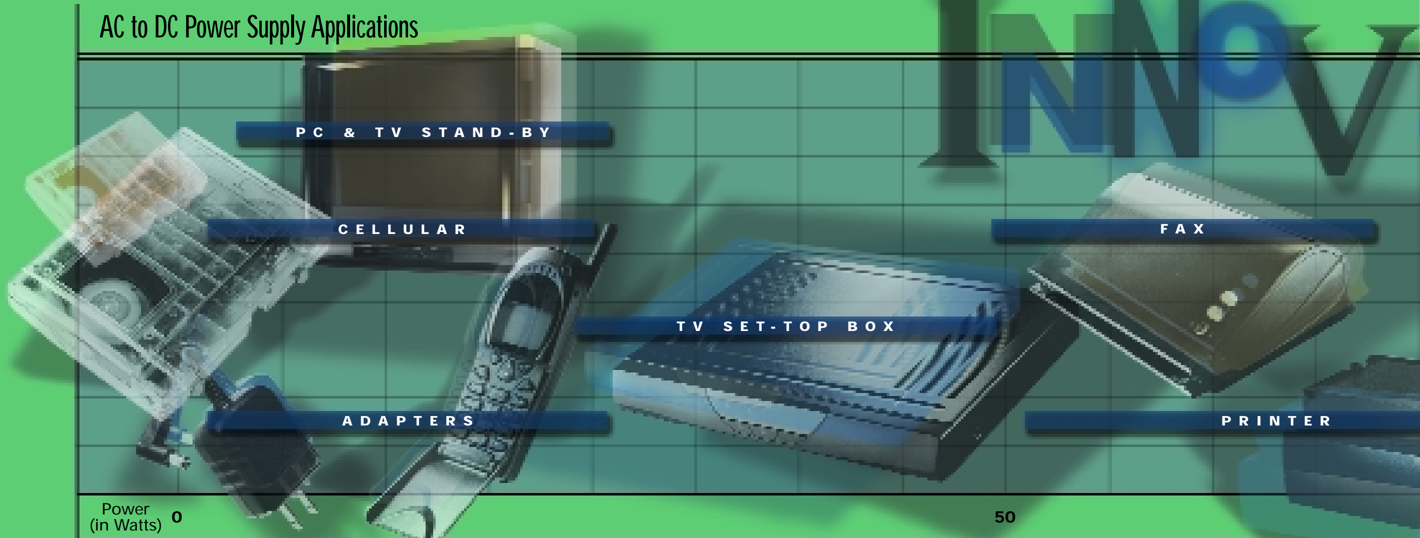
POWER play

leadership through the

We have sustained industry leadership through continuous innovation. Our recently introduced *TOPSwitch®-FX*, a new product family that builds on our highly successful *TOPSwitch* architecture, will give greater flexibility to designers who have demanding application requirements. *TOPSwitch-FX* improves our current competitive position in our existing markets, while allowing us to move more aggressively into new markets such as printers, DVDs and LCD monitors.

We also completed development of a new high-voltage silicon structure and process. This second-generation silicon structure offers our customers improved system performance at a lower cost, further enhancing our competitive position. Higher-power products, which we are introducing in 2000, will open up new markets by enabling us to compete more effectively further up the power range.

Additional patents are pending for our new FX product family and our new silicon technology, building on our existing intellectual property portfolio of 25 U.S. and 33 foreign patents.



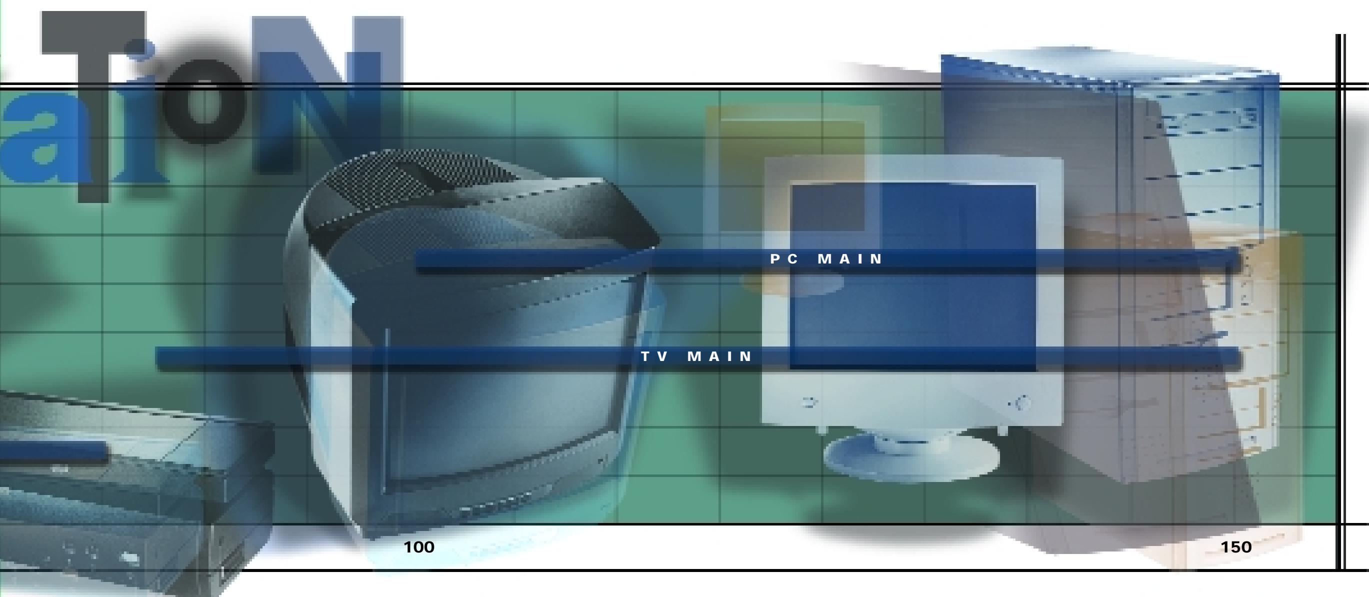
POWER of innovation

COMMITMENT TO GREENER SOLUTIONS

Our technological innovation has allowed us to stay ahead of the curve in global trends. Since introducing *TinySwitch* in 1998, we have seen increased awareness among government regulators and policy movement supportive of more energy-efficient devices. Both the scientific community and the marketplace have rewarded our IC solutions to the global issue of energy waste. Our *TinySwitch* product line, based on our new energy-saving *EcoSmart* technology, won Discover Magazine's prestigious 1999 Award for Technological Innovation in the environment category.

We believe this is the first time a silicon chip has been recognized for its contribution to the environment. We created the *EcoSmart* technology to stop the energy leakage that occurs, even when products are turned off. In TV standby power supplies, for example, *TinySwitch* cuts the energy wasted during "sleep mode" by up to 90 percent. *TinySwitch* also effectively "unplugs" a battery charger when a cell phone or other electronic device is not attached.

EcoSmart solutions will potentially translate into billions of dollars of energy savings worldwide. Because of the growing demand for more energy efficient solutions to convert power, we are incorporating our *EcoSmart* technology into most of our future products.



the total

Process Technology
· Cost-effective high-voltage CMOS process · Over 5 years of high volume production · Patented device technology
Circuit Technology
· Scalable system design topology · Analog, digital and high-voltage circuits · Patented circuit and system know-how
Applications Support
· Application labs worldwide · Staffed with design experts · Local real-time technical assistance
Design Support
· Design Accelerator Kits · Engineering Prototype boards · Full documentation and samples · Technical website designed for engineers · Step-by-step design methodology · Design software

Some companies stop at the chips — not Power Integrations. Our chips are only one part of a "whole product" that also includes comprehensive applications support through dedicated software tools and applications engineers in labs around the world. In fact, approximately one third of our technical resources are applications engineers.

POWER solution

BROADENING OUR REACH, BUILDING OUR CUSTOMER BASE

In 1999 we continued to invest in the technical resources needed to support our customers in all phases of the design-to-production cycle during implementation of a PI solution.

People We invested heavily in talented sales, marketing, engineering and IT professionals to increase the rate of new product introductions and expand technical support for design engineers around the world.

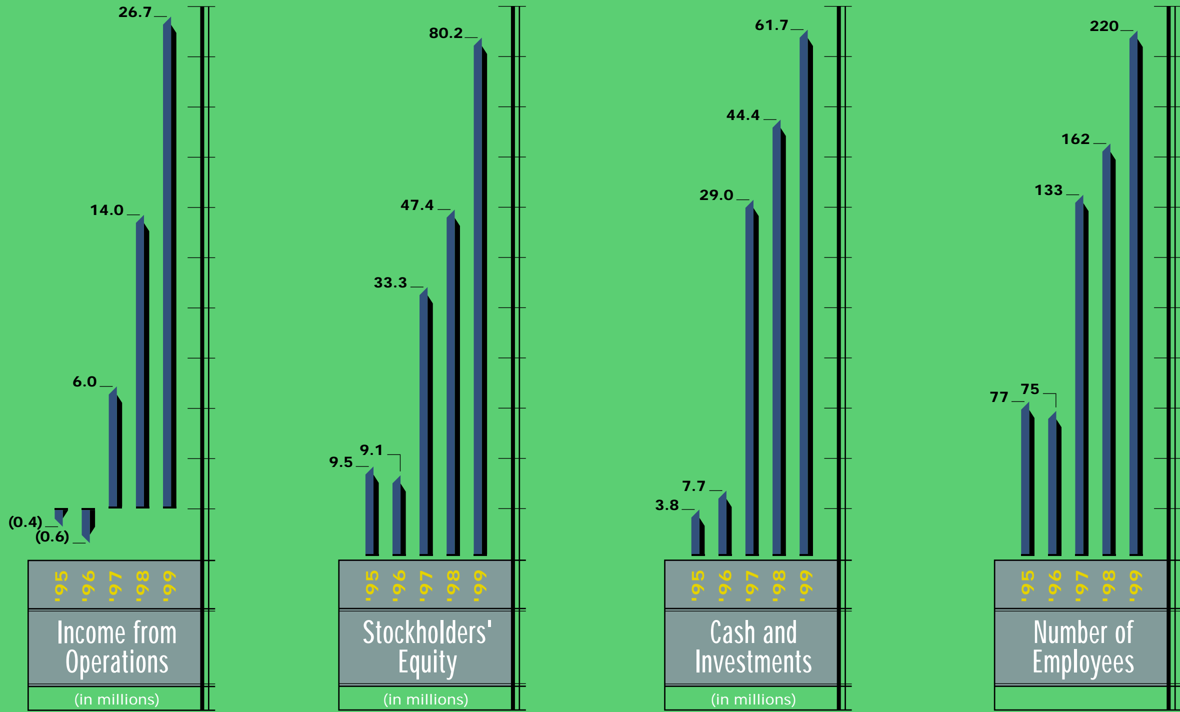
Global Expansion We opened new sales and design support offices in China and Germany in order to expand our presence in these potentially high growth markets.

Design Software We developed a new software tool that simplifies the design-in of PI products worldwide. We believe this sophisticated, but easy-to-use tool, will aid designers with smaller volume applications and further diversify our markets in a highly leveraged manner.

Technical Website We continue to expand our technical website to help engineers worldwide efficiently design power supplies using our ICs.

These investments have helped us to make substantial progress in continuing to build a worldwide franchise of engineers who will specify our products.

1999



Since the introduction of our first cost-effective IC, *TOPSwitch*, in 1994, we have experienced substantial growth, with a compound average rate exceeding 50% since 1995. Through quarterly revenue patterns that reflect seasonality, we have achieved record income from operations in each of the past eight quarters. Our margins reflect our strategy of maximizing market penetration in high volume, cost sensitive markets by passing along much of the cost savings we achieve to our customers. Overall, we expect this strategy to yield the greatest return to our stockholders.

POWER review

1999 FINANCIAL RESULTS

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The following selected consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and the Notes thereto included elsewhere in this Annual Report.

	For the Years Ended December 31,				
	1999	1998	1997	1996	1995
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net revenues:					
Product sales	$102,655	$ 68,206	$ 44,827	$ 23,324	$ 17,406
License fees and royalties	1,412	1,802	1,162	619	1,009
Total net revenues	104,067	70,008	45,989	23,943	18,415
Cost of revenues	46,794	36,638	26,291	15,546	12,371
Gross profit	57,273	33,370	19,698	8,397	6,044
Operating expenses:					
Research and development	10,764	7,231	5,253	3,519	2,044
Sales and marketing	11,085	8,468	6,417	3,905	2,744
General and administrative	8,760	3,641	2,053	1,558	1,619
Total operating expenses	30,609	19,340	13,723	8,982	6,407
Income (loss) from operations	26,664	14,030	5,975	(585)	(363)
Interest and other income (expense), net	2,147	1,248	(683)	(726)	(406)
Income (loss) before provision for income taxes	28,811	15,278	5,292	(1,311)	(769)
Provision for income taxes	4,334	2,600	530	30	34
Net income (loss)	$ 24,477	$ 12,678	$ 4,762	$ (1,341)	$ (803)
Earnings (loss) per share:					
Basic	$ 0.94	$ 0.52	$ 1.26	$ (0.78)	$ (0.69)
Diluted	$ 0.87	$ 0.48	$ 0.25	$ (0.78)	$ (0.69)
Shares used in per share calculation:					
Basic	25,958	24,426	3,776	1,712	1,170
Diluted	28,197	26,452	18,678	1,712	1,170

	As of December 31,				
	1999	1998	1997	1996	1995
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 61,672	$ 44,418	$ 29,008	$ 7,692	$ 3,800
Working capital	71,169	42,988	30,131	9,769	7,435
Total assets	98,571	65,054	48,559	19,535	15,279
Long-term debt and capitalized lease obligations, net of current portion	1,393	1,963	2,435	5,499	2,219
Stockholders' equity	80,248	47,364	33,327	9,098	9,512

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

Overview

We design, develop, manufacture and market proprietary, high-voltage, analog integrated circuits, commonly referred to as ICs, for use in AC to DC power conversion primarily for the cellular telephone, personal computer, cable and direct broadcast satellite and various consumer electronics markets. From our inception in March 1988 through 1993, we developed numerous standard and custom products incorporating high levels of features and functionality, each intended to address the needs of various markets. Although we succeeded in developing the core of our patented technology during this period, market penetration of our products was low because these products were not as cost-effective as alternative products. Limited product revenue and the high costs associated with developing and marketing numerous solutions to numerous target markets resulted in our being unprofitable.

In 1993, we changed our strategy to focus on bringing cost-effective, integrated products to the high-voltage AC to DC power supply markets. As a result, in 1994, we completed development of TOPSwitch, the first in our family of cost-effective, high-voltage, power conversion ICs. The TOPSwitch family of products, with its proprietary integrated architecture, is designed to address with relatively few products broad applications in a number of high-volume, high-voltage AC to DC power supply markets. The initial target markets served by TOPSwitch are particularly sensitive to size, portability, energy efficiency and time-to-market. The TOPSwitch products and the solutions enabled by them are significantly lower in cost than our previous products and the solutions enabled by those products. Commercial shipments of TOPSwitch began in May 1994. Primarily as a result of the increasing sales of TOPSwitch products, our net revenues from product sales more than tripled between 1994 and 1995, increasing from $5.0 million to $17.4 million. Net revenues from product sales increased sequentially by 34% in 1996, 92% in 1997, 52% in 1998 and 51% in 1999.

By focusing on the TOPSwitch family of products, we were able to more effectively utilize our resources and limit the growth of operating expenses in 1994 and 1995. Because of this and the growth in net revenues, operating expenses were reduced from 77.5% of net revenues in 1994 to 34.8% of net revenues in 1995. In response to increasing market acceptance of our TOPSwitch products and faster revenue growth in 1996, we accelerated our investment in research and development, and sales and marketing, including technical customer support. As a result, operating expenses were $9.0 million in 1996, $13.7 million in 1997, $19.3 million in 1998 and $30.6 million in 1999. Operating expenses in 1999 included approximately $4.1 million in additional legal costs related to the lawsuit filed against Motorola. Our legal expenses associated with the Motorola litigation are expected to decline in future quarters. However, we expect that all of our other operating expenses will increase in absolute dollars, but will fluctuate as a percentage of net revenues, as we continue to add resources to research and development, sales and marketing, and general and administrative activities.

Our quarterly and annual operating results are volatile and difficult to predict. Our net revenues and operating results have varied significantly in the past, are difficult to forecast and are subject to numerous factors both within and outside of our control. As a result, our quarterly and annual operating results may fluctuate significantly in the future. For a discussion of the factors that may affect our quarterly and annual

operating results, please see Factors that May Affect Future Results of Operations.

We license certain technologies and grant limited product manufacturing and marketing rights to strategic parties in return for foundry relationships, license fees and product royalty arrangements. Prior to the introduction of TOPSwitch in 1994, our analog ICs generated limited product sales while license fees and prepaid royalties accounted for a significant percentage of our total revenues. In future periods, we expect license fees and royalties to consist primarily of royalties on products shipped by licensees incorporating licensed technology, and anticipate that license fees and royalties will account for a small percentage of net revenues.

A portion of our cost of revenues consists of the cost of wafers. The contract prices to purchase wafers from Matsushita Electronics Corporation and OKI Electric Industry are denominated in Japanese yen. Changes in the exchange rate between the U.S. dollar and the Japanese yen subject our gross profit and operating results to the potential for material fluctuations. From time to time, as these strategic parties close old production lines and move to new fabrication facilities, we must absorb a portion of the costs of physically moving the manufacturing of our products to new production lines, including the costs of installation of new process technologies.

Product revenues consist of sales to OEMs and merchant power supply manufacturers and to distributors. Revenues from product sales to OEMs and merchant power supply manufacturers are recognized upon shipment. At that time, we provide for estimated sales returns and other allowances related to those sales. Between 40 and 50 percent of our sales are made to distributors under terms allowing certain rights of return and price protection for our products held in the distributors' inventories. Therefore, we defer recognition of revenue and the proportionate cost of revenues derived from sales to distributors until the distributors resell our products to their customers. The gross profit deferred as a result of this policy is reflected as "deferred income on sales to distributors" on our consolidated balance sheet. See note 2 of notes to consolidated financial statements.

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 the Years Ended December 31,		
	1999	**1998**	**1997**
Net revenues:			
Product sales	98.6%	97.4%	97.5%
License fees and royalties	1.4	2.6	2.5
Total net revenues	100.0	100.0	100.0
Cost of revenues	45.0	52.3	57.2
Gross profit	55.0	47.7	42.8
Operating expenses:			
Research and development	10.3	10.3	11.4
Sales and marketing	10.7	12.1	14.0
General and administrative	8.4	5.2	4.4
Total operating expenses	29.4	27.6	29.8
Income from operations	25.6	20.1	13.0
Interest and other income (expense), net	2.1	1.8	(1.5)
Income before provision for income taxes	27.7	21.9	11.5
Provision for income taxes	4.2	3.7	1.1
Net income	23.5%	18.2%	10.4%

Comparison of Years Ended December 31, 1998 and 1999

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 increased 48.7% from $70.0 million in 1998 to $104.1 million in 1999. Net revenues from product sales represented $68.2 million and $102.7 million of net revenues in 1998 and 1999, respectively. The increase in net revenues from product sales was due primarily to strong demand for our products across all of our major markets and geographies. In particular, sales to the cellular phone market accounted for approximately 39% of our product revenues for 1999 compared to 26% of product revenues in 1998, and increased 118% over 1998 sales to that market. Sales of our TOPSwitch and TinySwitch products represented 97% and 95% of net revenues from product sales in 1999 and 1998, respectively. Net revenues from royalties were $1.4 million in 1999 compared to $1.8 million in 1998. We expect net revenues from royalties to continue to account for a small percentage of our net revenues.

International sales were $81.6 million in 1999 compared to $58.1 million in 1998, representing approximately 78% and 83% of net revenues in those respective periods. Although the power supplies using our products are designed and distributed worldwide, most of these power supplies are manufactured in Asia. As a result, the largest portion of our net revenues is derived from sales to this region. We expect international sales to continue to account for a large portion of our net revenues.

In 1999, two separate customers accounted for approximately 16% and 11% of net revenues. In 1998, the same customers accounted for approximately 22% and 13% of net revenues, respectively. See note 2 of notes to consolidated financial statements.

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 from Matsushita and OKI, the assembly and packaging of our products, and internal labor and overhead associated with the testing of both wafers and packaged components. These costs include expenses incurred in connection with the physical move of the manufacturing of our products between wafer production lines at our foundry suppliers and with the installation of new process technologies at these foundries. These costs may recur from time to time and adversely affect our cost of revenues.

Gross profit increased from $33.4 million, or 47.7% of net revenues in 1998, to $57.3 million, or 55.0% of net revenues, in 1999. Efficiencies realized from higher volumes, reductions in wafer costs and improved test yields contributed to the improvement in gross profit. Gross profit also benefited from a one-time credit from one of our wafer suppliers in the amount of $1.4 million recorded in 1999. The credit improved our gross profit by 1.3% for the year. We cannot assure you that these or other factors will have a favorable impact on our gross profit in future periods.

Research and development expenses. Research and development expenses consist primarily of employee-related expenses, and 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 increased by approximately 48.9%, from $7.2 million in 1998 to $10.8 million in 1999. The increase was primarily the result of increased salaries and other costs related to the hiring of additional engineering personnel, outside consulting fees and expensed prototype materials resulting from the transition of foundry manufacturing processes, and bringing newly developed products into manufacturing. These expenses remained unchanged as a percentage of net revenues at 10.3% in both 1998 and 1999.

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 and support offices. Sales and

marketing expenses increased approximately 30.9%, from $8.5 million in 1998 to $11.1 million in 1999, which represented 12.1% and 10.7% of net revenues in each respective period. This increase in absolute dollars represents the addition of personnel to support international sales and field application engineers.

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. In 1998 and 1999, general and administrative expenses were $3.6 million and $8.8 million, respectively, which represented 5.2% and 8.4% of net revenues in each respective period. This increase in general and administrative expenses was primarily attributable to increased professional and legal expenses related to our patent infringement lawsuit filed against Motorola.

Interest and other income, net. Interest and other income, net, was $1.2 million and $2.1 million in 1998 and 1999, respectively. The increase in other income reflected additional interest income related to the increase in cash equivalents and short-term investments from 1998 to 1999, and lower interest expense related to a reduction in our capital equipment lease obligations.

Provision for income taxes. Provision for income taxes for 1998 and 1999 represents Federal, state and foreign taxes. The effective tax rate was 17% for 1998 and 15% for 1999. The difference between the statutory rate and our effective tax rate for 1998 and 1999 is due to the impact of benefiting net operating loss carryforwards, offset by the reduction in the deferred tax valuation allowance. See note 7 of notes to consolidated financial statements.

Comparison of Years Ended December 31, 1997 and 1998

Net revenues. Net revenues increased 52.2% from $46.0 million in 1997 to $70.0 million in 1998. Net revenues from product sales represented $44.8 million and $68.2 million of net revenues in 1997 and 1998, respectively. The increase in net revenues from product sales was due primarily to increased sales of our TOPSwitch family of products, which represented 95% of product sales in 1998. The migration from TOPSwitch to TOPSwitch II resulted in TOPSwitch II accounting for 45% of product sales in 1998 compared to 15% for 1997. We began commercial shipment of TOPSwitch II in April 1997. Net revenues also grew because of an increase in royalty revenues, from $1.2 million in 1997 to $1.8 million in 1998.

International sales increased by $20.9 million in 1998 compared to 1997, growing from approximately 81% of net revenues in 1997 to approximately 83% of net revenues in 1998. Although the power supplies using our products are designed and distributed worldwide, most of these power supplies are manufactured in Asia. As a result, the largest portion of our net revenues is derived from sales to this region.

In 1998, two separate customers accounted for approximately 22% and 13% of net revenues. In 1997, one of the same customers and one different customer accounted for approximately 21% and 15% of net revenues, respectively. See note 2 of notes to consolidated financial statements.

Cost of revenues; Gross profit. Gross profit increased from $19.7 million, or 42.8% of net revenues, to $33.4 million, or 47.7% of net revenues, in 1997 and 1998, respectively. Efficiencies realized from higher volumes, reductions in both wafers and packaging costs, improved test yields and a favorable foreign exchange rate between the U.S. dollar and the Japanese yen through most of the year contributed to the improvement in gross profit.

Research and development expenses. Research and development expenses increased by approximately 37.7%, from $5.3 million in 1997 to $7.2 million in 1998. The increase was primarily the result of increased salaries and other costs related to the hiring of additional engineering personnel, outside consulting fees and expensed prototype materials resulting from the transition of foundry manufacturing processes with Matsushita and OKI. These expenses decreased as a percentage of net revenues from 11.4% in 1997 to 10.3% in 1998 due to increased sales.

Sales and marketing expenses. Sales and marketing expenses increased approximately 32%, from $6.4 million in 1997 to $8.5 million in 1998, which represented 14.0% and 12.1% of net revenues, respectively. This increase represented the addition of personnel to support international sales and field application engineers.

General and administrative expenses. In 1997 and 1998, general and administrative expenses were $2.1 million and $3.6 million, respectively, which represented 4.4% and 5.2% of net revenues, respectively. This increase in absolute dollars was primarily attributable to increased professional and legal expenses related to our patent infringement lawsuit filed against Motorola.

Interest and other income (expense), net. Interest and other income (expense), net, was $683,000 net expense in 1997 and $1.2 million net income in 1998. The net expense in 1997 reflected interest incurred on capital equipment lease obligations and on $3.0 million of subordinated debt, which originated in the second quarter of 1996, partially offset by interest income earned on cash and short-term investments. The net income in 1998 reflected an increase in interest income due to the increase in cash and short-term investments from 1997 to 1998, and the reduction in interest expense due to the repayment of the subordinated debt in 1997.

Provision for income taxes. Provision for income taxes for 1997 and 1998 represented Federal, state and foreign taxes. The effective tax rate was 10% for 1997 and 17% for 1998 reflecting the profitable results for both years. The difference between the statutory rate and our effective tax rate for 1997 and 1998 was due to the impact of benefiting net operating loss carryforwards, offset by the reduction in the deferred tax valuation allowance. See note 7 of notes to consolidated financial statements.

Selected Quarterly Results of Operations

The following tables set forth certain consolidated statement of operations data for each of the quarters in the years ended December 31, 1999 and 1998, as well as the percentage of our net revenues represented by each item. This information has been derived from our unaudited consolidated financial statements. The unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements contained herein and include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of such information when read in conjunction with our annual audited consolidated financial statements and notes thereto appearing elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results for any subsequent period or for the entire fiscal year.

	Three Months Ended							
	Dec. 31, 1999	Sept. 30, 1999	June 30, 1999	Mar. 31, 1999	Dec. 31, 1998	Sept. 30, 1998	June 30, 1998	Mar. 31, 1998
	(in thousands, except per share data)							
Net revenues:								
Product sales	$ 29,725	$ 29,829	$ 22,655	$ 20,446	$ 19,750	$ 19,907	$ 14,647	$ 13,902
License fees and royalties	402	311	324	375	402	410	466	524
Total net revenues	30,127	30,140	22,979	20,821	20,152	20,317	15,113	14,426
Cost of revenues	14,178	12,667	10,482	9,467	9,773	10,635	8,254	7,976
Gross profit	15,949	17,473	12,497	11,354	10,379	9,682	6,859	6,450
Operating expenses:								
Research and development	3,080	2,813	2,535	2,336	2,005	1,947	1,720	1,559
Sales and marketing	2,988	2,893	2,729	2,475	2,479	2,376	1,724	1,889
General and administrative	1,640	4,324	1,427	1,369	1,296	1,067	730	548
Total operating expenses	7,708	10,030	6,691	6,180	5,780	5,390	4,174	3,996
Income from operations	8,241	7,443	5,806	5,174	4,599	4,292	2,685	2,454
Interest and other income, net	620	510	433	584	473	399	189	187
Income before provision for income taxes	8,861	7,953	6,239	5,758	5,072	4,691	2,874	2,641
Provision for income taxes	1,346	1,185	939	864	865	351	721	663
Net income	$ 7,515	$ 6,768	$ 5,300	$ 4,894	$ 4,207	$ 4,340	$ 2,153	$ 1,978
Earnings per share:								
Basic	$ 0.28	$ 0.26	$ 0.21	$ 0.19	$ 0.17	$ 0.18	$ 0.09	$ 0.08
Diluted	$ 0.26	$ 0.24	$ 0.19	$ 0.18	$ 0.16	$ 0.17	$ 0.08	$ 0.08
Shares used in per share calculation:								
Basic	26,440	26,275	25,814	25,289	24,904	24,459	24,174	24,160
Diluted	28,916	28,589	28,183	27,425	27,074	26,256	26,118	26,261

	Percentage of Total Net Revenues							
	Dec. 31, 1999	Sept. 30, 1999	June 30, 1999	Mar. 31, 1999	Dec. 31, 1998	Sept. 30, 1998	June 30, 1998	Mar. 31, 1998
Net revenues:								
Product sales	98.7%	99.0%	98.6%	98.2%	98.0%	98.0%	96.9%	96.4%
License fees and royalties	1.3	1.0	1.4	1.8	2.0	2.0	3.1	3.6
Total net revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Cost of revenues	47.1	42.0	45.6	45.5	48.5	52.3	54.6	55.2
Gross profit	52.9	58.0	54.4	54.5	51.5	47.7	45.4	44.8
Operating expenses:								
Research and development	10.2	9.4	11.0	11.2	9.9	9.6	11.4	10.8
Sales and marketing	9.9	9.6	11.9	11.9	12.3	11.7	11.4	13.1
General and administrative	5.4	14.3	6.2	6.6	6.4	5.3	4.8	3.8
Total operating expenses	25.5	33.3	29.1	29.7	28.6	26.6	27.6	27.7
Income from operations	27.4	24.7	25.3	24.8	22.9	21.1	17.8	17.1
Interest and other income, net	2.1	1.7	1.9	2.8	2.4	1.9	1.2	1.3
Income before provision for income Taxes	29.5	26.4	27.2	27.6	25.3	23.0	19.0	18.4
Provision for income taxes	4.5	3.9	4.1	4.1	4.3	1.7	4.8	4.6
Net income	25.0%	22.5%	23.1%	23.5%	21.0%	21.3%	14.2%	13.8%

Net revenues increased sequentially in the first, second and third quarters of both 1999 and 1998, and were essentially unchanged from the third quarter to the fourth quarter each year. Increases in product sales were due to growth in the volume of sales from existing customers, the addition of new customers and the introduction of the TinySwitch family of products in the third quarter of 1998. Sequential net revenues were unchanged in the fourth quarters of 1999 and 1998 due, we believe, to the seasonal nature of some of our markets.

Our gross profit increased as a percentage of net revenues during each of the seven quarters ended September 30, 1999 and was down in the quarter ended December 31, 1999. The gross profit improvements generally were due to efficiencies realized from higher volumes, reductions in material costs and improved test yields. The third quarter of 1999 benefited approximately 4% from a one-time credit from one of our wafer suppliers. The lower gross profit margin in the fourth quarter was primarily due to continued pricing pressures from our customers and a weakening dollar versus Japanese yen.

Research and development expenses increased in absolute terms during the eight quarters presented, primarily due to increased staffing in the areas of new product design and technology development. Due to increases in net revenues, research and development expenses remained relatively unchanged as a percent of total net revenues.

Sales and marketing expenses generally increased in absolute dollars over the eight quarters presented, primarily due to the additional staffing in sales and application engineering and increased sales commissions due to the increased revenues from product sales. Sales expenses were down in the first and second quarters of 1998 due to reduced commissions because of lower seasonal net revenues.

General and administrative expenses increased over the eight quarters presented with significant increases from the third quarter of 1998 through the end of 1999 primarily due to increased legal expense related to our patent infringement lawsuit filed against Motorola.

Interest and other income, net essentially increased over the eight quarters presented primarily from increased interest income due to higher cash balances created by a net positive cash flow as well as cash proceeds from our initial public offering in December 1997.

Liquidity and Capital Resources

Since our initial public offering of common stock in December 1997, our principal source of funding has been cash from our operations with some funding from capital equipment lease lines.

As of December 31, 1999, we had approximately $61.7 million in cash, cash equivalents and short-term investments. In addition, under a revolving line of credit agreement 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 those foundries to us. The balance of this credit line is unused and available. The line of credit agreement contains financial covenants and requires 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. We financed additional equipment during the year ended December 31, 1999 in the amount of $772,000. We may obtain additional financing for equipment purchases in future quarters. As of December 31, 1999, we owed approximately $2.9 million on our various capital equipment leases.

As of December 31, 1999, we had working capital, defined as current assets less current liabilities, of approximately $71.2 million, which was an increase of approximately $28.2 million over December 31, 1998. Our operating activities generated cash of $22.9 million and $18.5 million in the year ended December 31, 1999 and 1998, respectively. Cash generated in the

year ended December 31, 1999, was principally the result of net income in the amount of $24.5 million, depreciation and amortization, tax benefits from employee stock plans and increases in accounts payable and accrued liabilities. This was partially offset by increases in accounts receivable, inventory and deferred income taxes. Cash generated in the year ended December 31, 1998, was principally the result of net income of $12.7 million, depreciation and amortization, increases in deferred revenue, accounts receivable and accrued liabilities, offset by an increase in inventories and a decrease in accounts payable.

Our investing activities were a net transfer from cash and cash equivalents to short-term investments of $13.5 million and $16.8 million for the years ended December 31, 1999 and 1998, respectively. We also purchased capital assets in the amount of $6.6 million and $2.0 million for the years ended December 31, 1999 and 1998, 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.

Year 2000 Readiness Disclosure

To date, we have not experienced any disruption in our products as a result of, nor has any third-party vendor on whom we depend been affected by, the commencement of the year 2000. Although we do not anticipate that our products will be affected by the year 2000, if we, or our third-party providers, fail to remedy any year 2000 issues, the result could be lost revenues, increased operating expenses, the loss of customers and other business interruptions, any of which could harm our business. The failure to adequately address year 2000 compliance issues in the delivery of products to our customers could result in litigation against us, which could be costly and time consuming to defend.

In light of our experiences to date, we have not developed any further contingency plans for year 2000 issues beyond those preparations made prior to January 1, 2000. Our worst-case scenario for year 2000 problems would be our inability to provide our products and services to our customers and resultant decline in total revenues.

New Accounting Standards

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, hedging activities, and exposure definition. SFAS No. 133 requires companies to recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. We do not expect the adoption of SFAS No. 133 to have a material impact on our financial statements.

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 will adopt SAB 101 as required in the first quarter of 2000 and are evaluating the effect that such adoption may have on our consolidated results of operations and financial position.

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 and annual 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 will likely 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.

Our quarterly results may be subject to seasonality. Historically, our revenues are strongest in our third and fourth quarters, due to what we believe are seasonal factors attributed to the high volume consumer markets for the end products into which our ICs are sold. Our revenues have then followed a pattern of being sequentially linear or somewhat down in the first and second quarters of the next year.

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 cancelled or rescheduled without significant penalty to the customer. 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.

We depend on Motorola for a significant portion of our net revenues and if we lose Motorola as a customer, our operating results will suffer. For 1999, direct sales to Motorola accounted for approximately 9% of our net revenues. Indirect sales, through power supply merchants, which incorporate our ICs into the products they produce for Motorola, accounted for approximately 13% of our net revenues. For the quarter ended December 31, 1999, direct sales and indirect sales to Motorola accounted for approximately 8% and 16% of our net revenues, respectively. We expect that our operating results, in part, will depend on our direct and indirect sales to Motorola for the foreseeable future.

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 cellular phone battery charger and desktop personal computer stand-by markets, our net revenues will decrease. Applications of our products in the cellular phone battery chargers and desktop personal computer, or PC, stand-by markets have and will continue to account for the majority of our net revenues. We expect that our net revenues and operating results will continue to be substantially dependent upon these markets for the foreseeable future. The cellular phone and desktop PC markets can be highly cyclical and have been subject to significant economic downturns at various times. Any significant downturn in these markets could cause our net revenues to decline and the price of our stock to fall. In addition, technological advances in these markets may reduce demand for our products.

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 his/her 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 may 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. Our contract with Matsushita terminates in June 2000, and if we cannot extend our agreement with Matsushita, our net revenues may decline. 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 provide wafers to us is limited by the available capacity of the foundry in which they manufacture wafers for us. 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 available from only one vendor, 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 potentially large Japanese market for our products is largely 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. In addition, we have agreed not to sell our products in Japan to new customers. 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.

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. 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 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.

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.

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, and on our ability to continue to attract, retain and motivate qualified personnel, such as experienced systems applications engineers. 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 do not have long-term employment contracts with, and we do not have in place key person life insurance policies on, any of our employees.

Our recent growth has strained our resources and if we fail to successfully manage this growth, we may lose customers. We have experienced a period of rapid growth and expansion, which has placed, and continues to place, a significant strain on our resources. Relationships with our customers generally

require significant engineering support. A significant increase in the number of customers using our technology will increase the strain on our resources, particularly our engineers. These strains may result in delays or difficulties in our research and development process, which could impede our ability to develop future generations of our products and to remain competitive. In addition, any future periods of rapid growth or expansion could be expected to place a significant strain on our limited managerial, financial and engineering resources.

We have adopted anti-takeover measures, which may make it more difficult for a third party to acquire us. 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.

In February 1999, our board of directors adopted a preferred stock purchase rights plan 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. The existence of this plan could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting 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.

Quantitative and Qualitative Disclosure About Market Risks

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 December 31, 1999. All investments mature, by policy, in 15 months or less.

Foreign Currency Exchange Risk. We transact business in various foreign countries. Our primary foreign currency cash flows are in Japan 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.

(in thousands, except average interest rates)

	Carrying Amount	Average Interest Rate
Cash Equivalents:		
U.S. corporate securities	$ 5,488	6.64%
Tax-exempt securities	20,500	4.33%
Total cash equivalents	25,988	4.82%
Short-term Investments:		
U.S. corporate securities	17,897	5.28%
Foreign securities	3,079	4.97%
Tax-exempt securities	11,999	3.73%
Total short-term investments	32,975	4.68%
Total investment securities	$ 58,963	4.74%

To Power Integrations, Inc.:

We have audited the accompanying consolidated balance sheets of Power Integrations, Inc. (a Delaware corporation) and subsidiaries as of December 31, 1999 and 1998, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Power Integrations, Inc. and subsidiaries as of December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles.

Arthur Andersen LLP
San Jose, California
January 18, 2000
(except with respect to the matter discussed in note 8, as to which is dated March 14, 2000)

	As of December 31,	
	1999	**1998**
	(In thousands, except share and per share amounts)	
Assets		
Current Assets:		
Cash and cash equivalents	$ 27,883	$ 24,176
Short-term investments	33,789	20,242
Accounts receivable, net of allowances of $990 in 1999 and $1,293 in 1998	9,682	4,640
Inventories	11,406	8,845
Prepaid expenses and other current assets	5,339	812
Total current assets	88,099	58,715
Property and Equipment, at Cost:		
Machinery and equipment	21,632	14,716
Leasehold improvements	1,394	1,158
	23,026	15,874
Less: Accumulated depreciation and amortization	(12,554)	(9,535)
	10,472	6,339
	$ 98,571	$ 65,054
Liabilities and Stockholders' Equity		
Current Liabilities:		
Current portion of capitalized lease obligations	$ 1,228	$ 1,950
Accounts payable	6,524	5,866
Accrued payroll and related expenses	3,994	2,394
Taxes payable and other accrued liabilities	1,818	2,951
Deferred income on sales to distributors	3,366	2,566
Total current liabilities	16,930	15,727
Capitalized Lease Obligations, net of current portion	1,393	1,963
Commitments (Note 4)		
Stockholders' Equity:		
Convertible Preferred Stock, $0.001 par value		
Authorized—3,000,000 shares		
Outstanding—none	—	—
Common Stock, $0.001 par value		
Authorized—40,000,000 shares		
Outstanding—26,468,272 shares in 1999 and 24,994,128 shares in 1998	26	25
Additional paid-in capital	65,553	57,276
Common stock warrants	—	12
Stockholder notes receivable	(201)	(274)
Deferred compensation	(181)	(321)
Cumulative translation adjustment	(129)	(57)
Retained earnings (deficit)	15,180	(9,297)
Total stockholders' equity	80,248	47,364
	$ 98,571	$ 65,054

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

	For the Years Ended December 31,		
	1999	1998	1997
	(In thousands, except per share amounts)		
Net Revenues:			
Product sales	$ 102,655	$ 68,206	$ 44,827
License fees and royalties	1,412	1,802	1,162
Total net revenues	104,067	70,008	45,989
Cost of Revenues	46,794	36,638	26,291
Gross Profit	57,273	33,370	19,698
Operating Expenses:			
Research and development	10,764	7,231	5,253
Sales and marketing	11,085	8,468	6,417
General and administrative	8,760	3,641	2,053
Total operating expenses	30,609	19,340	13,723
Income from Operations	26,664	14,030	5,975
Other Income (Expense):			
Interest income	2,515	1,801	359
Interest expense	(302)	(432)	(832)
Other, net	(66)	(121)	(210)
Total other income (expense)	2,147	1,248	(683)
Income Before Provision for Income Taxes	28,811	15,278	5,292
Provision for Income Taxes	4,334	2,600	530
Net Income	$ 24,477	$ 12,678	$ 4,762
Earnings Per Share:			
Basic	$ 0.94	$ 0.52	$ 1.26
Diluted	$ 0.87	$ 0.48	$ 0.25
Shares Used in Per Share Calculation:			
Basic	25,958	24,426	3,776
Diluted	28,197	26,452	18,678

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

For the Years Ended December 31, 1999, 1998, 1997 (in thousands)

	Convertible Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount
Balance at December 31, 1996	91,728	$ 35,271	1,752	$ 565
Issuance of Common Stock under employee stock option plan	—	—	2,099	982
Issuance of Common Stock in connection with Public Offering	—	—	5,400	5
Conversion of Preferred Stock to Common Stock	(91,728)	(35,271)	14,895	15
Change in par value	—	—	—	(2,108)
Deferred compensation	—	—	—	566
Amortization of deferred compensation	—	—	—	—
Translation adjustment	—	—	—	—
Net income	—	—	—	—
Balance at December 31, 1997	—	—	24,146	25
Issuance of Common Stock under employee stock option plan, net of repurchases	—	—	275	—
Issuance of Common Stock under employee stock purchase plan	—	—	184	—
Exercise of warrants, net	—	—	389	—
Proceeds of stockholder note repayment	—	—	—	—
Income tax benefit from employee stock option plan	—	—	—	—
Additional IPO costs	—	—	—	—
Amortization of deferred compensation	—	—	—	—
Translation adjustment	—	—	—	—
Net income	—	—	—	—
Balance at December 31, 1998	—	—	24,994	25
Issuance of Common Stock under employee stock option plan, net of repurchases	—	—	769	1
Issuance of Common Stock under employee stock purchase plan	—	—	351	—
Exercise of warrants, net	—	—	354	—
Proceeds of stockholder note repayment	—	—	—	—
Income tax benefit from employee stock option plan	—	—	—	—
Amortization of deferred compensation	—	—	—	—
Translation adjustment	—	—	—	—
Net income	—	—	—	—
Balance at December 31, 1999	—	$ —	26,468	$ 26

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

Additional Paid-In Capital	Warrants	Stockholder Notes Receivable	Deferred Compensation	Cumulative Translation Adjustment	Retained Earnings (Deficit)	Total Stockholders' Equity
$ —	$ 12	$ —	$ —	$ (13)	$ (26,737)	$ 9,098
3	—	(405)	—	—	—	580
18,840	—	—	—	—	—	18,845
35,256	—	—	—	—	—	—
2,108	—	—	—	—	—	—
—	—	—	(566)	—	—	—
—	—	—	105	—	—	105
—	—	—	—	(63)	—	(63)
—	—	—	—	—	4,762	4,762
56,207	12	(405)	(461)	(76)	(21,975)	33,327
247	—	—	—	—	—	247
627	—	—	—	—	—	627
46	—	—	—	—	—	46
—	—	131	—	—	—	131
240	—	—	—	—	—	240
(91)	—	—	—	—	—	(91)
—	—	—	140	—	—	140
—	—	—	—	19	—	19
—	—	—	—	—	12,678	12,678
57,276	12	(274)	(321)	(57)	(9,297)	47,364
1,678	—	—	—	—	—	1,679
1,267	—	—	—	—	—	1,267
12	(12)	—	—	—	—	—
—	—	73	—	—	—	73
5,320	—	—	—	—	—	5,320
—	—	—	140	—	—	140
—	—	—	—	(72)	—	(72)
—	—	—	—	—	24,477	24,477
$ 65,553	$ —	$ (201)	$ (181)	$ (129)	$ 15,180	$ 80,248

	1999	1998	1997
		For the Years Ended December 31, (in thousands)	
Cash Flows from Operating Activities:			
Net income	$ 24,477	$ 12,678	$ 4,762
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,231	3,034	2,265
Deferred compensation expense	140	140	105
Deferred income taxes	(3,918)	240	—
Provision for (reduction in) accounts receivable and other allowances	(303)	24	984
Change in operating assets and liabilities:			
Accounts receivable	(4,738)	1,579	(4,450)
Inventories	(2,561)	(1,517)	(3,390)
Prepaid expenses and other current assets	(610)	(463)	(49)
Accounts payable	656	(1,036)	5,427
Accrued liabilities	5,716	2,637	1,754
Deferred income on sales to distributors	800	1,186	646
Net cash provided by operating activities	22,890	18,502	8,054
Cash Flows from Investing Activities:			
Purchases of property and equipment	(6,592)	(1,956)	(1,439)
Purchases of short-term investments	(52,070)	(47,904)	(13,402)
Proceeds from sales and maturities of short-term investments	38,524	31,117	14,357
Net cash used in investing activities	(20,138)	(18,743)	(484)
Cash Flows from Financing Activities:			
Net proceeds from issuance of common stock	2,946	828	19,425
Proceeds from stockholder note repayment	73	131	—
Principal payments under capitalized lease obligations	(2,064)	(2,095)	(1,724)
Repayment related to note payable to a stockholder	—	—	(3,000)
Net cash provided by (used in) financing activities	955	(1,136)	14,701
Net Increase (decrease) in Cash and Cash Equivalents	3,707	(1,377)	22,271
Cash and Cash Equivalents at Beginning of Period	24,176	25,553	3,282
Cash and Cash Equivalents at End of Period	$ 27,883	$ 24,176	$ 25,553
Supplemental Disclosure of Non-cash Investing and Financing Activities:			
Capitalized lease obligations incurred for property and equipment	$ 772	$ 1,786	$ 1,630
Conversion of preferred stock to common stock	$ —	$ —	$ 35,271
Supplemental Disclosure of Cash Flow Information:			
Cash paid for interest	$ 312	$ 445	$ 832
Cash paid for income taxes	$ 3,208	$ 714	$ 164

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

1. The Company:

Power Integrations, Inc. (the ''Company''), which was incorporated in California on March 25, 1988, and reincorporated in Delaware in December 1997 (see Note 6), designs, develops, manufactures and markets proprietary, high-voltage, analog integrated circuits for use in AC to DC power conversion primarily for the cellular telephone, personal computer and various consumer and industrial electronics markets.

The Company is subject to a number of risks including, among others, the volume and timing of orders received by the Company from its customers; competitive pressures on selling prices; the volume and timing of orders placed by the Company with its foundries; the availability of raw materials; fluctuations in manufacturing yields, whether resulting from the transition to new foundries or from other factors; changes in product mix, including the impact of new product introductions on existing products; the Company's ability to develop and bring to market new products and technologies on a timely basis; the introduction of products and technologies by the Company's competitors; market acceptance of the Company's and its customers' products; the timing of investments in research and development, and sales and marketing; cyclical semiconductor industry conditions; fluctuations in exchange rates, particularly exchange rates between the U.S. dollar and the Japanese yen; and changes in the international business climate and economic conditions.

All of the wafers are manufactured by two offshore independent foundries. Although there are a number of other suppliers that could provide similar services, a change in suppliers could cause a delay in manufacturing and possible loss of sales, which could adversely affect operating results.

2. Summary of Significant Accounting Policies:

Principles of Consolidation and Foreign Currency Translation

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

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 December 31, 1999 and 1998, the Company's short-term investments consist 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.

The table below summarizes the value of the Company's investments by major security type as of December 31, 1999 and 1998:

	As of December 31,	
	1999	1998
Cash Equivalents:	(in thousands)	
U.S. corporate securities	$ 5,488	$ 15,596
Tax-exempt securities	20,500	—
Total cash equivalents	25,988	15,596
Short-term Investments:		
U.S. corporate securities	17,897	14,881
U.S. government securities	—	959
Foreign securities	3,079	3,922
Tax-exempt securities	11,999	—
Total short-term investments	32,975	19,762
Total investment securities	$ 58,963	$ 35,358

Inventories

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

	December 31,	
	1999	1998
Raw materials	$ 4,039	$ 3,132
Work-in-process	4,059	2,901
Finished goods	3,308	2,812
	$ 11,406	$ 8,845

Property and Equipment

Depreciation and amortization of property and equipment are provided using the straight-line method over the shorter of the estimated useful lives of the assets over a period of one to four years or over the applicable lease term.

Included in property and equipment are assets acquired under capital lease obligations with an original cost of approximately $9.0 million and $8.2 million, as of December 31, 1999 and 1998, respectively. Related accumulated amortization on these leased assets was approximately $5.7 million and $4.7 million, as of December 31, 1999 and 1998, respectively.

Earnings Per Share

In December 1997, the Company adopted Statement of Financial Accounting Standards (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 is calculated by dividing net income by the weighted average shares of common stock outstanding during the period. Diluted earnings per share is 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 warrants computed using the treasury stock method.

A summary of the earnings per share calculation for each of the three years ended December 31, 1999, 1998 and 1997, is as follows (in thousands, except per share amounts):

	1999	1998	1997
Basic Earnings Per Share:			
Net income	$ 24,477	$ 12,678	$ 4,762
Weighted average common shares	25,958	24,426	3,776
Basic earnings per share	$ 0.94	$ 0.52	$ 1.26
Diluted Earnings Per Share:			
Net income	$ 24,477	$ 12,678	$ 4,762
Weighted average common shares	25,958	24,426	3,776
Weighted average common share equivalents:			
Preferred stock	—	—	14,078
Options	2,170	1,446	578
Employee stock purchase plan	69	10	—
Warrants	—	570	246
Diluted weighted average common shares	28,197	26,452	18,678
Diluted earnings per share	$ 0.87	$ 0.48	$ 0.25

Comprehensive Income

In June 1997, the Financial Accounting Standards Board issued SFAS No. 130, ''Reporting Comprehensive Income,'' which establishes standards for reporting and presentation of comprehensive income. SFAS No. 130, which was adopted by the Company in the first quarter of 1998, requires companies to report a new measure of income. ''Comprehensive Income'' is to include foreign currency translation gains and losses and other unrealized gains and losses that have historically been excluded from net income and reflected instead in equity. SFAS No. 130 did not have a material impact on the Company's financial statements.

Segment Reporting

During 1998, the Company adopted 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, the design, development, manufacture and marketing of proprietary, high-voltage, analog integrated circuits for use primarily in the AC to DC power conversion markets.

New Accounting Standards

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, hedging activities and exposure definition. SFAS No. 133 requires companies to recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The Company does not expect the adoption of SFAS No. 133 to have a material impact on its financial statements.

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 will adopt SAB 101 as required in the first quarter of 2000 and is evaluating the effect that such adoption may have on its consolidated results of operations and financial position.

Revenue Recognition, Significant Customers

Product revenues consist of sales to OEMs and merchant power supply manufacturers and to distributors. Revenues from product sales to OEM and merchant power supply manufacturers are recognized upon shipment. The Company provides for estimated sales returns and allowances related to such sales at the time of shipment. During 1999, 1998 and 1997, sales to distributors of the Company's products accounted for approximately 40%, 48% and 45% of net revenues, respectively. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines of the Company's products held by the distributors. Pursuant to the Company's distributor agreements, the Company protects its distributors' exposure related to the impact of price reductions as well as products at distributors that are slow moving or have been discontinued. These agreements, which may be cancelled by either party on a specified notice, generally contain a provision for the return of the Company's product in the event the agreement with the distributor is terminated. Accordingly, the Company defers recognition of revenue and the proportionate costs of revenues derived from sales to distributors until such 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 consolidated balance sheets.

The Company has entered into a separate wafer supply and technology license agreement with an unaffiliated wafer foundry. The wafer supply agreement, which expires in June 2000, is renewable. In connection with the technology license agreement, the Company is entitled to receive a royalty on sales of products by the foundry, which incorporates the Company's technology into its own products. For the years ended December 31, 1999, 1998 and 1997, revenue recognized under this agreement was approximately \$1.4 million, \$1.8 million and \$1.2 million, respectively.

The Company's end user base is highly concentrated and a relatively small number of OEMs, directly or indirectly through merchant power supply manufacturers, accounted for a significant portion of the Company's revenue. For the years ended December 31, 1999, 1998 and 1997, ten customers accounted for approximately 68%, 67% and 67% of net revenues, respectively.

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

	For the Years Ended December 31,		
	1999	**1998**	**1997**
Customer A	16%	22%	21%
Customer B	*	*	15%
Customer C	11%	13%	*

*less than 10% or no sales to the customer

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. Export sales, which consist of domestic sales to customers in foreign countries, are comprised of the following:

	For the Years Ended December 31,		
	1999	**1998**	**1997**
Hong Kong/China	20%	26%	25%
Taiwan	19%	26%	28%
Western Europe	16%	15%	12%
Korea	13%	7%	5%
Japan	2%	3%	5%
Other	8%	6%	6%
Total export sales	78%	83%	81%

Product Sales

Sales of TOPSwitch products accounted for 97%, 95% and 93% of net revenues in 1999, 1998 and 1997, respectively. TOPSwitch products include TOPSwitch, TOPSwitch II and TinySwitch.

Foreign Currency Risk

The Company maintains a Japanese yen bank account with a U.S. bank for payments to suppliers and for cash receipts from Japanese suppliers and customers denominated in yen. For the years ended December 31, 1999 and 1998, the Company realized foreign exchange transaction gains of approximately $123,000 and $35,000, respectively. For the year ended December 31, 1997, the Company realized a foreign exchange transaction loss of approximately $86,000. These amounts are included in "other income (expense)," in the accompanying consolidated statements of operations.

Estimates

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

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 short-term, low risk investments. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers' financial condition and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past losses and other relevant information. As of December 31, 1999 and 1998, approximately 73% and 67% of accounts receivable, respectively, were concentrated with ten customers.

3. Bank Line of Credit:

The Company entered into a $10.0 million revolving line of credit agreement with a bank in October 1998. Advances under the agreement bear interest at a fixed rate of the bank's LIBOR rate plus 1.5% per annum or at the bank's variable interest rate. The Company has the option to choose between the two rates. The agreement covers advances for commercial letters of credit and standby letters of credit, used primarily for the shipment of wafers from our wafer supply manufacturers to us, provided that at no time will the aggregate sum of all advances exceed $10.0 million. As of December 31, 1999, there were outstanding letters of credit totaling 96,587,000 Japanese yen (approximately $964,000). As of December 31, 1998, there were outstanding letters of credit totaling 382,478,000 Japanese yen (approximately $3.4 million). The agreement, which expires on November 30, 2000, restricts the Company from entering into certain transactions and contains certain financial covenants.

4. Commitments:

The Company leases its facilities under noncancellable operating leases, which expire at various dates through October 2010. The lease for the Company's main corporate facility in Sunnyvale, California expires in October 2003, and contains a conditional five-year option at fair-market value to the year 2008. The Company also has an additional facility, which is leased through June 2003. On December 29, 1999, the Company entered into a lease for a new facility, which will become available in mid 2000, at which time the Company plans to relocate its main operations to that site. The lease on the new facility has a term of 10 years, expiring in May 2010, with two conditional five-year options, which if exercised would extend the lease to May 2020. Rent expense under all operating leases was approximately $1.1 million, $500,000 and $291,000 in 1999, 1998 and 1997, respectively.

A significant portion of the Company's machinery and equipment is leased under agreements accounted for as capital leases. The Company leased approximately $772,000 and $1.8 million of equipment during 1999 and 1998, respectively, under various capital leasing arrangements. In 1998, the Company entered into a new capital lease line of credit agreement, which allowed for combined borrowings of up to $4.4 million to finance the acquisition of property and equipment. The capital leasing agreement expired on June 30, 1999.

Future minimum lease payments under all noncancellable operating and capital lease agreements as of December 31, 1999, are as follows (dollars in thousands):

Fiscal Year	Operating	Capital
2000	$ 2,185	$ 1,373
2001	3,157	758
2002	3,066	463
2003	2,859	241
2004	2,126	42
Thereafter	12,997	—
Total minimum lease payments	$ 26,390	2,877
Less: Amounts representing interest on capital leases (4.4% to 14.9%)		(256)
		2,621
Less: Current portion		(1,228)
Long-term portion		$ 1,393

5. Preferred Stock Purchase Rights Plan:

In February 1999, the Company adopted a Preferred Stock Purchase Rights Plan (the "Plan") designed to enable all stockholders to realize the full value of their investment and to provide for fair and equal treatment for all stockholders in the event that an unsolicited attempt is made to acquire the Company. Under the Plan, stockholders received one right to purchase one one-thousandth of a share of a new series of preferred stock for each outstanding share of common stock held of record at the close of business on March 12, 1999, at $150.00 per right, when someone acquires 15 percent or more of the Company's common stock or announces a tender offer which could result in such person owning 15 percent or more of the common stock. Each one one-thousandth of a share of the new preferred stock has terms designed to make it substantially the economic equivalent of one share of common stock. Prior to someone acquiring 15 percent, the rights can be redeemed for $0.001 each by action of the board of directors. Under certain circumstances, if someone acquires 15 percent or more of the common stock, the rights permit the stockholders other than the acquirer to purchase the Company's common stock having a market value of twice the exercise price of the rights, in lieu of the preferred stock. Alternatively, when the rights become exercisable, the board of directors may authorize the issuance of one share of common stock in exchange for each right that is then exercisable. In addition, in the event of certain business combinations, the rights permit the purchase of the common stock of an acquirer at a 50 percent discount. Rights held by the acquirer will become null and void in both cases. The rights expire on February 23, 2009.

6. Stockholders' Equity:

Preferred Stock

With the closing of the Company's IPO in December 1997, all of the outstanding convertible preferred stock automatically converted into 14,895,116 shares of common stock. Upon conversion of the outstanding preferred stock to common stock, such preferred stock was retired. The Company is authorized to issue 3,000,000 shares of new $0.001 par value preferred stock, of which none was outstanding as of December 31, 1999.

Common Stock

As of December 31, 1999, the Company was authorized to issue 40,000,000 shares of $0.001 par value common stock. On October 25, 1999, the Company's board of directors approved a two-for-one split of the Company's common stock, in the form of a 100 percent stock dividend, that was applicable to stockholders of record at the close of business on November 8, 1999,

and effective on November 22, 1999. All references to share and per-share data for all periods presented have been adjusted to give effect to this two-for-one stock split.

1988 Stock Option Plan

In June 1988, the board of directors approved the 1988 Stock Option Plan (the ''1988 Plan''), whereby the board of directors may grant options to key employees, directors and consultants to purchase the Company's common stock at exercise prices of not less than 85% of the fair value of the shares at the date of grant. Options expire ten years after the date of grant (five years if the option is granted to a ten percent owner optionee) and generally vest over 50 months. Options granted under the 1988 Plan will remain outstanding in accordance with their terms, but effective July 1997, the board of directors had determined that no further options would be granted under the 1988 Plan.

1997 Stock Option Plan

In June 1997, the board of directors approved the 1997 Stock Option Plan (the ''1997 Plan''), whereby the board of directors may grant options to key employees, directors and consultants to purchase the Company's common stock at exercise prices of not less than 85% of the fair value of the shares at the date of grant. As of December 31, 1999, the 1997 Plan's maximum share reserve is 5,514,160 shares, which is comprised of the sum of (i) 2,571,196 shares (new shares allocated to the 1997 Plan) and (ii) 2,942,964 shares granted pursuant to the 1988 Plan (the ''1988 Plan Options''). The number of shares available for issuance under the 1997 Plan, at any time, is reduced by the number of shares remaining subject to the 1988 Plan Options. Options expire ten years after the date of grant (five years if the option is granted to a ten percent owner optionee) and generally vest over 48 months.

1997 Outside Directors Stock Option Plan

In September 1997, the board of directors approved an Outside Director Stock Option Plan (the ''Directors Plan''). A total of 400,000 shares of common stock have been reserved for issuance under the Directors Plan. The Directors Plan provides for the grant of nonstatutory stock options to nonemployee directors of the Company. The Directors Plan is designed to work automatically without administration; however, to the extent administration is necessary, it will be performed by the board of directors. The Directors Plan provides that each current and future nonemployee director of the Company will be granted an option to purchase 30,000 shares of common stock on the effective date or the date on which the optionee first becomes a nonemployee director of the Company after the effective date as the case may be (the ''Initial Grant''). Thereafter, each nonemployee director who has served on the board of directors continuously for 6 months will be granted an additional option to purchase 10,000 shares of common stock (an ''Annual Grant''). Subject to an optionee's continuous service with the Company, approximately 1/3rd. of an Initial Grant will become exercisable one year after the date of grant and 1/36th. of the Initial Grant will become exercisable monthly thereafter. Each Annual Grant will become exercisable in twelve monthly installments beginning in the 25th. month after the date of grant, subject to the optionee's continuous service. The exercise price per share of all options granted under the Directors Plan will equal the fair-market value of a share of common stock on the date of grant. Options granted under the Directors Plan have a term of ten years and are non-transferable. In the event of certain changes in control of the Company, options outstanding under the Directors Plan will become immediately exercisable and vested in full.

1998 Nonstatutory Stock Option Plan

In July 1998, the board of directors approved the 1998 Nonstatutory Stock Option Plan (the "1998 Plan"), whereby the board of directors may grant nonstatutory options to employees and consultants to purchase the Company's common stock at exercise prices of not less than 85% of the fair value of the shares at the date of grant. As of December 31, 1999, the maximum share reserve under this plan was 1,000,000 shares. Options expire ten years after the date of grant (five years if the option is granted to a ten percent owner optionee) and generally vest over 48 months.

The following table summarizes option activity under the Company's option plans:

(prices are weighted average prices)	For the Years Ended December 31,					
	1999		1998		1997	
	Shares	Price	Shares	Price	Shares	Price
Options Outstanding,						
Beginning of Year:	2,666,422	$ 3.11	1,749,512	$ 1.38	2,592,852	$ 0.40
Granted	1,704,875	18.06	1,317,300	5.08	1,324,864	1.35
Exercised	(769,316)	2.15	(275,476)	0.89	(2,099,204)	0.28
Cancelled	(272,906)	11.23	(124,914)	3.28	(69,000)	0.71
Options Outstanding,						
End of Year	3,329,075	$ 10.40	2,666,422	$ 3.11	1,749,512	$ 1.38
Exercisable, End of Year	723,496	$ 3.71	727,348	$ 1.11	475,258	$ 0.49

Options issued under the 1988, 1997 and 1998 plans may be exercised at any time prior to their expiration. Options issued under the Directors Plan are exercisable upon vesting. In addition, the Company has the right, upon termination of an optionholder's employment or service with the Company, at its discretion, to repurchase any unvested shares issued under the 1988, 1997 and 1998 plans at the original purchase price. Under the terms of the option plans, an option holder may not sell shares obtained upon the exercise of an option until the option has vested as to those shares. As of December 31, 1999, an aggregate of 148,240 shares of common stock issued under the 1988, 1997 and 1998 plans are subject to repurchase by the Company at $0.68 to $0.85 per share and a weighted average repurchase price of $0.81 per share.

The Company accounts for its Plans under APB Opinion No. 25, "Accounting for Stock Issued to Employees." Had compensation expense for the Plans been determined under a fair value method consistent with SFAS No. 123, "Accounting for Stock Based Compensation," the Company's net income would have been decreased to the following pro forma amounts (in thousands, except per share information):

	For the Years Ended December 31,		
	1999	1998	1997
Net Income:			
As reported	$ 24,477	$ 12,678	$ 4,762
Pro forma	$ 18,891	$ 11,599	$ 4,427
Basic Earnings Per Share:			
As reported	$ 0.94	$ 0.52	$ 1.26
Pro forma	$ 0.73	$ 0.47	$ 1.17
Diluted Earnings Per Share:			
As reported	$ 0.87	$ 0.48	$ 0.25
Pro forma	$ 0.67	$ 0.44	$ 0.24

The weighted-average grant date fair value of options granted during fiscal years 1999, 1998 and 1997, was $11.85, $10.15 and $1.68, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in 1999, 1998 and 1997: risk-free interest rates of 5.625, 5.25 and 6.2 percent, respectively; expected dividend yields of zero percent; expected lives of 1.5 years for 1999 and 1998, and 4 years for 1997; expected volatility of 84%, 73% and 70% for 1999, 1998 and 1997, respectively.

The following table summarizes the stock options outstanding at December 31, 1999:

	Options Outstanding			Options Exercisable	
Exercise Price	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
$ 0.26 - $4.00	595,536	6.75	$ 1.08	410,319	$ 0.98
$ 4.25 - $4.38	916,336	8.50	$ 4.37	144,699	$ 4.37
$ 4.42 - $11.06	301,405	8.28	$ 8.94	98,209	$ 5.60
$12.00 - $29.19	1,363,623	9.31	$ 14.22	69,269	$ 15.43
$30.69 - $51.50	152,175	9.79	$ 26.84	1,000	$ 33.20
$ 0.26 - $51.50	3,329,075	8.56	$ 10.40	723,496	$ 3.71

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the "Purchase Plan"), 1,000,000 shares of common stock are reserved for issuance to eligible employees. The Purchase Plan permits employees to purchase common stock through payroll deductions, which may not exceed 15 percent of an employee's compensation, at 85% of the lower of the fair-market value of the Company's common stock on the first or the last day of each offering period. As of December 31, 1999, 534,770 shares had been purchased and 465,230 shares were reserved for future issuance under the Purchase Plan.

Stockholder Notes Receivable

In July 1997, in connection with the purchase of common stock upon exercise of stock options granted to certain officers and employees of the Company, the Company loaned to these officers and employees an aggregate of $405,000, at an interest rate of 6.65% pursuant to Promissory Note and Pledge Agreements. These loans, which are secured by 238,231 shares of common stock, are full recourse notes, and are due in full without regard to the value of the Company's common stock in July 2002, or at the Company's option upon (i) termination of employment with the Company, (ii) a default in the payment of any installment or principal and/or interest when due, (iii) a sale of the pledged stock or (iv) acceleration being reasonably necessary for the Company to comply with any regulations promulgated by the Board of Governors of the Federal Reserve System affecting the extension of credit in connection with the Company's securities. As of December 31, 1999, the unpaid principal portion of these loans was $201,000.

Deferred Compensation

In connection with the issuance of stock options to employees and consultants prior to December 1997, the Company recorded deferred compensation in the aggregate amount of approximately $566,000, repre-

senting the difference between the fair-market value of the Company's common stock and the exercise price of the stock options at the date of grant. The Company is amortizing the deferred compensation expense over the shorter of the period in which the employee, director or consultant provides services or the applicable vesting period, which is typically over 48 months. Amortization expense was $140,000 in each of the years ended December 31, 1999 and 1998, and $105,000 in 1997. Compensation expense is decreased in the period of forfeiture for any accrued, but unvested compensation arising from the early termination of an option holder's services. No compensation expense related to any other periods presented has been recorded.

Warrants

In connection with the issuance of Series E Preferred Stock in 1994, the Company issued warrants for the purchase of Series E Preferred Stock, which upon the completion of the IPO and the reincorporation in Delaware, were automatically converted to purchase 20,728 shares of common stock at $5.74 per share. These warrants were exercised in 1998.

In connection with an equipment lease agreement entered into during 1993 with a leasing company, the Company issued a warrant for the purchase of preferred stock. Upon the completion of the IPO and the reincorporation in Delaware, the warrant was automatically converted to purchase 16,303 shares of common stock at $3.68 per share. This same warrant provides for the purchase of additional preferred stock, which, upon the completion of the IPO and the reincorporation in Delaware, was automatically converted to purchase 12,551 shares of common stock at $4.78 per share. This warrant was exercised in 1999. The Company leased additional equipment during 1994 from the same company and, as part of this lease, the Company issued a warrant for the purchase of preferred stock. Upon the completion of the IPO and the reincorporation in Delaware, the warrant automatically converted into a warrant to purchase 12,551 shares of common stock at $4.78 per share. This warrant was exercised in 1999. In 1995, the Company leased additional equipment from the same company and issued a warrant to purchase preferred stock, which upon the completion of the IPO and the reincorporation in Delaware, automatically converted into a warrant to purchase 24,509 shares of common stock at $3.67 per share. This warrant was exercised in 1999.

In connection with an equipment leasing agreement entered into during 1995 with a leasing company, the Company issued a warrant to purchase 41,165 shares of the Company's common stock at $6.34 per share. This warrant was exercised in 1998.

In connection with obtaining the revolving line of credit agreement with a bank in 1995, the Company issued the bank warrants to purchase preferred stock. Upon the completion of the IPO and the reincorporation in Delaware, the warrants were automatically converted to purchase 146,786 shares of common stock at $3.67 per share. These warrants were exercised in 1998. In connection with the renewal of the line of credit agreement in 1996, the Company issued the bank a warrant to purchase 23,149 shares of common stock at $6.34 per share. This warrant was exercised in 1998.

In connection with the issuance of a note payable to a stockholder in 1996, the Company issued a warrant to purchase 176,470 shares of the Company's common stock at $1.36 per share. This warrant was exercised in 1999.

Shares Reserved

As of December 31, 1999, the Company had 4,256,118 shares of common stock reserved for future issuance under stock option and stock purchase plans.

7. Income Taxes:

The Company accounts for income taxes under SFAS No. 109 "Accounting for Income Taxes." SFAS No. 109 provides for a liability approach to accounting for income taxes under which deferred income taxes are provided based upon enacted tax laws and rates applicable to the periods in which taxes become payable.

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

	For the Years Ended December 31,		
	1999	1998	1997
Current Provision:			
Federal	$ 7,621	$ 1,886	$ 262
State	616	694	55
Foreign	15	20	16
	8,252	2,600	333
Deferred Provision (benefit):			
Federal	1,125	4,136	1,946
State	99	(103)	(404)
Foreign	—	—	—
	1,224	4,033	1,542
Net decrease in valuation allowance	(5,142)	(4,033)	(1,345)
	$ 4,334	$ 2,600	$ 530

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

	For the Years Ended December 31,		
	1999	1998	1997
Provision computed at Federal statutory rate	35.0%	35.0%	34.0%
State tax provision, net of Federal benefit	3.1	3.1	3.0
Foreign tax	—	0.1	0.3
Change in valuation allowance	(17.9)	(23.0)	(25.4)
Research and development credits	(3.4)	(3.0)	(6.2)
Foreign sales corporation	(2.5)	—	—
Nondeductible expenses and other	0.7	4.8	4.3
	15.0%	17.0%	10.0%

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

	As of December 31,	
	1999	1998
Tax credit carryforwards	$ 494	$ 1,128
Inventory reserves	1,896	2,283
Accounts receivable allowances	377	527
Accrued vacation	121	132
Other cumulative temporary differences	1,030	1,072
	3,918	5,142
Valuation allowance	—	(5,142)
	$ 3,918	$ —

The deferred tax asset of $3.9 million at December 31, 1999, is included in prepaid expenses and other current assets in the accompanying consolidated balance sheet. Realization of the deferred tax asset is dependent on generating sufficient future taxable income. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized.

As of December 31, 1999, the Company had research and development tax credit carryforwards of approximately $494,000. These carryforwards expire in various periods from 2010 to 2019. The United States Tax Reform Act of 1986 contains provisions that limit research and development credits available to be used in any given year upon the occurrence of certain events.

8. Legal Proceedings:

In July 1998, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against its largest end user, Motorola. In August 1998, the Company voluntarily dismissed the complaint, and filed a new complaint in the U.S. District Court, District of Delaware, alleging that Motorola has infringed and continues to infringe two of the Company's circuit patents. In October 1998, Motorola asserted various counterclaims against the Company, alleging that the Company is infringing certain of Motorola's patents.

Trial of this action was held in October 1999. On October 15, 1999, the jury returned a unanimous verdict in favor of the Company. The jury determined that Motorola had willfully infringed one of the Company's patents and awarded the Company $32.3 million in compensatory damages. The jury also found that the Company had not infringed any of the asserted Motorola patents and that two of the Motorola patents were invalid. In March 2000, the Company and Motorola entered into a settlement agreement. Pursuant to the settlement agreement, the Court has issued a permanent injunction prohibiting Motorola from selling the ICs that were the subject of the lawsuit. Additionally, the Company will not collect the money judgment from Motorola and will continue as a preferred supplier of high-voltage power conversion ICs for cellular phone chargers that Motorola manufactures. The companies will work more closely together to develop future generations of cellular phone chargers for Motorola.

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To obtain our Annual Report Form 10-K and other public information, visit our website at www.powerint.com (in pdf format) or by writing to the Corporate Secretary at the executive offices of the Company.

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