POWER INTEGRATIONS INC
Form 10-Q
November 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2007.

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number 0-23441

POWER INTEGRATIONS, INC.

(Exact name of registrant as specified in its charter)

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

5245 Hellyer Avenue, San Jose, California 95138

(Address of principal executive offices) (Zip code)

(408) 414-9200

(Registrant s telephone number, including area code)

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

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

Class	**Outstanding at October 31, 2007**
Common Stock, $.001 par value	29,615,431 shares

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. In some cases, forward-looking statements are indicated by the use of such words as would , could , will , may , expect , believe , should , anticipate , future , intend , plan , estimate , predict , potential , targets , seek or continue and similar words and phrases, including the negatives or other variations of such terms. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, our ability to maintain and establish strategic relationships; the risks inherent in the development and delivery of complex technologies; our ability to attract, retain and motivate qualified personnel; the emergence of new markets for our products and services, and our ability to compete in those markets based on timeliness, cost and market demand; competition from our competitors, including those that we believe are infringing our patents; and our limited financial resources. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we have no obligation (and expressly disclaim any such obligation) to update or alter any forward-looking statements, whether as a result of new information or otherwise. In evaluating these statements, you should specifically consider the risks described under Item 1A of Part II Risk Factors, Item 2 of Part I Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Quarterly Report on Form 10-Q.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(In thousands)

	September 30, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 162,402	$ 124,937
Restricted cash	1,300	1,300
Short-term investments	13,262	2,506
Accounts receivable, net of allowances of $411 and $527, respectively	14,652	10,489
Inventories	19,944	28,280
Deferred tax assets	2,047	2,199
Prepaid expenses and other current assets	3,794	4,009
Total current assets	217,401	173,720
INVESTMENTS	1,000	3,999
NOTE RECEIVABLE	10,000	10,000
PROPERTY AND EQUIPMENT, net	55,085	53,475
INTANGIBLE ASSETS, net	5,315	5,895
DEFERRED TAX ASSETS	13,190	13,485
OTHER ASSETS	272	285
Total assets	$ 302,263	$ 260,859
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 10,109	$ 8,592
Accrued payroll and related expenses	7,044	8,668
Income taxes payable	1,608	14,509
Deferred income on sales to distributors	5,574	4,901
Accrued professional fees	3,868	3,294
Other accrued liabilities	126	129
Total current liabilities	28,329	40,093
LONG-TERM INCOME TAXES PAYABLE	14,236	
Total liabilities	42,565	40,093
STOCKHOLDERS EQUITY:		
Common stock	29	29

Additional paid-in capital		153,081		135,307
Accumulated other comprehensive income		83		4
Retained earnings		106,505		85,426
Total stockholders equity		259,698		220,766
Total liabilities and stockholders equity	$	302,263	$	260,859

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

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POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
NET REVENUES	$ 49,806	$ 44,404	$ 138,363	$ 121,122
COST OF REVENUES COST OF REVENUES	23,409	20,355	62,897	54,622
GROSS PROFIT	26,397	24,049	75,466	66,500
OPERATING EXPENSES:				
Research and development	6,664	6,331	18,474	18,158
Sales and marketing	6,976	6,330	19,488	19,054
General and administrative	6,475	10,210	18,403	26,732
Total operating expenses	20,115	22,871	56,365	63,944
INCOME FROM OPERATIONS	6,282	1,178	19,101	2,556
OTHER INCOME				
Other income, net	1,917	1,585	5,223	4,357
Insurance reimbursement			723	
Total other income	1,917	1,585	5,946	4,357
INCOME BEFORE PROVISION FOR INCOME TAXES	8,199	2,763	25,047	6,913
PROVISION FOR INCOME TAXES	1,446	102	5,011	525
NET INCOME	$ 6,753	$ 2,661	$ 20,036	$ 6,388
EARNINGS PER SHARE:				
Basic	$ 0.23	$ 0.09	$ 0.70	$ 0.22
Diluted	$ 0.22	$ 0.09	$ 0.65	$ 0.21
SHARES USED IN PER SHARE CALCULATION:				
Basic	28,789	28,650	28,708	29,192
Diluted	31,342	29,832	30,987	30,887

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

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POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(In thousands)

	Nine Months Ended September 30, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 20,036	$ 6,388
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,040	5,164
Gain on sale of property, plant and equipment	(48)	
Stock-based compensation expense	9,816	11,823
Deferred income taxes	447	(1,596)
Provision for (reduction in) accounts receivable and other allowances	(55)	1,383
Excess tax benefit from stock options exercised	(131)	(169)
Tax benefit associated with employee stock plans	1,133	153
Change in operating assets and liabilities:		
Accounts receivable	(4,108)	(1,563)
Inventories	8,251	(8,624)
Prepaid expenses and other current assets	246	(2,856)
Accounts payable	1,521	4,903
Taxes payable and accrued liabilities	592	5,787
Deferred income on sales to distributors	673	1,906
Net cash provided by operating activities	44,413	22,699
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment (net of gain on asset disposition)	(7,026)	(7,933)
Acquisition of technology patents / licenses		(3,000)
Purchases of held-to-maturity investments	(15,864)	(24,851)
Proceeds from maturities of held-to-maturity investments	8,106	18,622
Net cash used in investing activities	(14,784)	(17,162)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from issuance of common stock	7,705	5,563
Repurchase of common stock		(19,643)
Excess tax benefit from stock options exercised	131	169
Net cash provided by (used in) financing activities	7,836	(13,911)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	37,465	(8,374)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	124,937	109,879
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 162,402	$ 101,505
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND		

FINANCING ACTIVITIES:				
Unpaid property and equipment	$	4	$	1,556
Deferred stock-based compensation	$		$	(746)
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid for income taxes, net	$	563	$	724

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

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION:

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

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2006, as presented in the Company s Form 10-K/A, filed on August 14, 2007 with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Cash and Cash Equivalents and Short-Term and Long-Term Investments

The Company considers cash invested in highly liquid financial instruments with maturities of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. As of September 30, 2007 and December 31, 2006, the Company s short-term and long-term investments consisted of U.S. government-backed securities, corporate commercial paper and other high-quality commercial securities, which were classified as held-to-maturity and were valued using the amortized-cost method, which approximates fair market value.

Restricted Cash

The Company s restricted cash balance of $1.3 million at September 30, 2007 consists of an interest-bearing certificate of deposit at Union Bank of California. The certificate of deposit bears interest at a rate of 3.55% and is renewed every three months. The current maturity for the certificate of deposit is January 28, 2008. The Company has entered into a security agreement with Union Bank of California, whereby the Company agreed to maintain $1.3 million in an interest-bearing certificate of deposit with the bank. The certificate of deposit is restricted because it was established in order to secure commercial letters of credit or standby letters of credit up to the deposit amount. As of September 30, 2007, there were two outstanding letters of credit totaling approximately $1.2 million. This agreement remains in effect until cancellation of the Company s letters of credit or until the Company reestablishes its line of credit with the Union Bank of California.

Revenue Recognition

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

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company s products held by the distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell the Company s products to their customers. The Company determines the amounts to defer based on the level of actual inventory on hand at its distributors as well as inventory that is in transit to its distributors. The gross profit that is deferred as a result of this policy is reflected as deferred income on sales to distributors in the accompanying condensed consolidated balance sheets.

Common Stock

On October 19, 2005, the Company announced that its board of directors had authorized a stock repurchase program of up to $25.0 million of the Company s common stock. During the six months ended June 30, 2006 the Company purchased 1.1 million shares of its common stock for $19.6 million. From inception of the stock repurchase program through June 30, 2006, the Company repurchased 1.3 million shares for a total of $25.0 million, concluding this program. The Company has not repurchased stock since the conclusion of this repurchase program in June 2006.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition and allowances for receivables and inventories. These estimates are based on historical facts and various other assumptions that the Company believes to be reasonable at the time the estimates are made.

Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Net income	$ 6,753	$ 2,661	$ 20,036	$ 6,388
Other comprehensive income:				
Translation adjustments	51	3	79	71
Total comprehensive income	$ 6,804	$ 2,664	$ 20,115	$ 6,459

Segment Reporting

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 and DC-to-DC power conversion markets. The Company s chief operating decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance.

3. STOCK PLANS AND STOCK-BASED COMPENSATION:

Stock Plans

As of September 30, 2007, the Company had four stock-based employee compensation plans, the Plans, which are described below.

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1997 Stock Option Plan

In June 1997, the board of directors adopted the 1997 Stock Option Plan (the 1997 Plan), whereby the board of directors may grant incentive stock options and non-qualified stock options to key employees, directors and consultants. The exercise price of incentive stock options may not be less than 100% of the fair market value of the Company s common stock on the date of grant. The exercise price of non-qualified stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. The 1997 Plan originally provided that the number of shares reserved for issuance automatically increased on each January 1st, from January 1, 1999 through January 1, 2007, by 5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. In January 2005, the board of directors amended the 1997 Plan to reduce the annual increase from 5% to 3.5%, so that the number of shares reserved for issuance automatically increase on each January 1st, from January 1, 2006 through January 1, 2007, by 3.5% of the total number of shares of common stock issued and outstanding on the last day of the preceding fiscal year. As of September 30, 2007 the maximum number of shares that may be issued under the 1997 Plan was 16,116,653. In general, options vest over 48 months. Options generally expire no later than ten years after the date of grant (five years if an incentive stock option is granted to a ten percent owner optionee), subject to earlier termination upon an optionee s cessation of employment or service.

1997 Outside Directors Stock Option Plan

In September 1997, the board of directors adopted the 1997 Outside Directors Stock Option Plan (the Directors Plan). A total of 800,000 shares of common stock have been reserved for issuance under the Directors Plan. The 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 for the automatic grant of nonstatutory stock options to non-employee directors of the Company over their period of service on the board of directors. The Directors Plan provides that each future non-employee director of the Company will be granted an option to purchase 30,000 shares of common stock on the date on which such individual first becomes a non-employee director of the Company (the Initial Grant). Thereafter, each non-employee director who has served on the board of directors continuously for 12 months will be granted an additional option to purchase 10,000 shares of common stock (an Annual Grant). 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 equal 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 is equal to the fair market value of a share of common stock on the date of grant. Options granted under the Directors Plan have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee s cessation of service. In the event of certain changes in control of the Company, all options outstanding under the Directors Plan will become immediately vested and exercisable in full.

1998 Nonstatutory Stock Option Plan

In July 1998, the board of directors adopted the 1998 Nonstatutory Stock Option Plan (the 1998 Plan), whereby the board of directors may grant nonstatutory stock options to employees and consultants, but only to the extent that such options do not require approval of the Company s stockholders. The 1998 Plan has not been approved by the Company s stockholders. The exercise price of nonstatutory stock options may not be less than 85% of the fair market value of the Company s common stock on the date of grant. As of September 30, 2007, the maximum number of shares that may be issued under the 1998 Plan was 1,000,000 shares. In general, options vest over 48 months. Options generally have a maximum term of ten years after the date of grant, subject to earlier termination upon an optionee s cessation of employment or service.

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee s compensation, to the purchase of shares of the Company s common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company s common stock on the first day of each two-year offering period, or (ii) the fair market value of the Company s common stock on the semi-annual purchase date. If the fair market value of the Company s common stock on any semi-annual purchase date within a two-year offering period is less than the fair market

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

value per share on the first day of such offering period, then immediately following purchase of shares of the Company s common stock on that semi-annual purchase date, participants will be automatically withdrawn from the offering period and enrolled in a new two-year offering period beginning immediately thereafter. An aggregate of 2,000,000 shares of common stock is reserved for issuance to employees under the Purchase Plan. As of September 30, 2007, 1,609,300 shares had been purchased and 390,700 shares were reserved for future issuance under the Purchase Plan. In April 2006 the Company temporarily suspended the Purchase Plan due to the Company s delisted status with the NASDAQ. In August 2007, subsequent to completing all delinquent SEC filings, the Company was relisted with the NASDAQ. The Company then reestablished employee payroll deductions for the Employee Stock Purchase Plan. The share purchase for these deductions will take place in the first quarter of 2008.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the fair-value recognition provisions of Statement of Financial Accounting Standards (SFAS 123R), *Share-Based Payment*. The Company previously applied Accounting Principles Board (APB) opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations, and provided pro forma disclosures of SFAS 123, *Accounting for Stock-Based Compensation*. The Company has elected to use the modified prospective transition method, as provided by SFAS 123R. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2007 and 2006 includes: 1) compensation in connection with the unvested portion of all stock-based compensation awards that were granted prior to January 1, 2006, and 2) compensation related to all stock option awards granted subsequent to December 31, 2005. The Company is using the accelerated method to amortize stock options granted through December 31, 2005 over the remaining requisite service period of the stock option award, and the straight-line method for all stock options granted after December 31, 2005 over the requisite service period of the award. In accordance with SFAS 123R, as of January 1, 2006, all deferred compensation previously recorded has been eliminated with a corresponding reduction in additional paid-in capital.

As of September 30, 2007 there was approximately $22.9 million, net of expected forfeitures, of total unrecognized compensation costs related to stock options. The unrecognized compensation costs are expected to be recognized over a weighted-average period of 2.4 years. A total of $3.9 million and $3.8 million was recorded as stock-based compensation expense in the three months ended September 30, 2007 and 2006, respectively, and $9.4 million and $11.8 million was recorded as stock-based compensation expense in the nine months ended September 30, 2007 and 2006, respectively.

Determining Fair Value

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

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

Expected Life. The Company uses the simplified method to calculate the expected life of stock option grants. This method assumes all options will be exercised midway between the vesting date and the contractual term of the option.

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

Dividends. The Company has not paid dividends in the past, nor does it have any current plans to pay dividends. As such, the Company uses a dividend yield percentage of zero.

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of stock options granted is established on the date of the grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Risk-free interest rates	4.55%	4.85%	4.55%-4.78%	4.46%-5.00%
Expected volatility rates	42%	49%	42%-44%	49%-52%
Expected dividend yield				
Expected life of stock options (years)	6.03	6.03	6.03	6.03
Weighted-average grant date fair value of options granted	$ 12.02	$ 8.45	$ 12.00	$ 13.20

The fair value of employees stock purchase rights under the Company s employee stock purchase plan was estimated using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Risk-free interest rates (1)	5.04%		5.04%	4.44%
Expected volatility rates (1)	35%		35%	37%
Expected dividend yield				
Expected life of purchase right (years)	1.0		1.0	1.0
Weighted-average estimated fair value of purchase rights (2)	$ 4.74		$ 4.74	$ 6.81

(1) In the three months ended September 30, 2006 the assumptions used for the risk-free interest rate and expected volatility rate were not applicable, as a result of the suspension of the Company s employee stock purchase plan due to the Company s delisted status with the NASDAQ.

(2) In the three months ended September 30, 2006 no employee stock purchases took place as a result of the suspension of the Company s employee stock purchase plan, and therefore no weighted-average estimated fair value of purchase rights was reported.

The following table summarizes the stock-based compensation expense recognized in accordance with SFAS No. 123R for the three and nine months ended September 30, 2007 and September 30, 2006 (in thousands).

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Stock-based compensation expense for stock options and employee stock purchases included in operations:				
Cost of revenues	$ 326	$ 448	$ 938	$ 907
Research and development	1,088	1,019	2,649	3,336
Sales and marketing	1,452	1,311	3,317	4,274
General and administrative	1,041	1,045	2,542	3,306

Total stock-based compensation expense	$ 3,907	$ 3,823	$ 9,446	$ 11,823

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of option activity under the Plans as of September 30, 2007, and changes during the nine months then ended, is presented below:

	Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2007	8,491	$ 20.18		
Granted	1,113	25.20		
Exercised	(524)	16.18		
Forfeited or expired	(63)	23.89		
Outstanding at September 30, 2007	9,017	$ 21.10	6.05	$ 80,432
Exercisable at September 30, 2007	6,349	$ 20.05	4.96	$ 64,137
Vested and expected to vest at September 30, 2007	8,584	$ 20.97	5.92	$ 77,822

The weighted-average grant-date fair value of options granted for the three and nine months ended September 30, 2007 was $12.02 and $12.00, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2007 was $5.9 million and $6.5 million, respectively.

4. INVENTORIES:

Inventories (which consist of costs associated with the purchase 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):

	September 30, 2007	December 31, 2006
Raw materials	$ 3,605	$ 7,869
Work-in-process	5,770	6,767
Finished goods	10,569	13,644
	$ 19,944	$ 28,280

5. INTANGIBLE ASSETS:

Intangible assets consist primarily of acquired licenses and patent rights and are reported net of accumulated amortization. The Company amortizes the cost of intangible assets over the term of the acquired license or patent rights, which ranges from five to twelve years. Amortization for all acquired intangible assets was approximately $0.2 million and $0.6 million in the three and nine months ended September 30, 2007, respectively, and $0.2 million and $0.5 million in the three and nine months ended September 30, 2006, respectively. The Company does not believe there is any significant residual value associated with the following intangible assets (in thousands):

	September 30, 2007			December 31, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Intangible Value	Gross Carrying Amount	Accumulated Amortization	Net Intangible Value
Patent rights	$ 3,165	$ (1,248)	$ 1,917	$ 3,165	$ (978)	$ 2,187
Technology licenses	4,057	(679)	3,378	4,057	(375)	3,682
Other intangibles	37	(17)	20	37	(11)	26
Total intangible assets	$ 7,259	$ (1,944)	$ 5,315	$ 7,259	$ (1,364)	$ 5,895

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The estimated future amortization expense related to intangible assets at September 30, 2007 is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2007 (remaining 3 months)	$ 194
2008	774
2009	763
2010	728
2011	696
Thereafter	2,160
Total	$ 5,315

6. SIGNIFICANT CUSTOMERS AND EXPORT SALES:

Customer Concentration

The Company s revenues are derived primarily from sales of its ICs to OEMs, power supply merchants and distributors. Ten customers accounted for approximately 65% and 66% of total net revenues for the three months ended September 30, 2007 and 2006, respectively, and 63% and 58% of the total net revenues for the nine months ended September 30, 2007 and 2006, respectively. A significant portion of these net revenues are attributable to sales of the Company s products through distributors of electronic components. These distributors sell the Company s products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers. One customer, a distributor of the Company s products, accounted for 24% and 26% of net revenues in the three months ended September 30, 2007 and 2006, respectively, and 25% and 21% of net revenues for the nine months ended September 30, 2007 and 2006, respectively. No other customer accounted for 10% or more of the Company s revenues in the periods mentioned.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company has cash investment policies that limit cash investments to low-risk investments. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers financial conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. As of September 30, 2007 and December 31, 2006, approximately 65% and 67% of accounts receivable, respectively, were concentrated with the top ten customers. One customer, a distributor of the Company s products, accounted for 16% and 22% of accounts receivable as of September 30, 2007, and December 31, 2006, respectively. No other customer accounted for 10% or more of accounts receivable in the periods mentioned.

Export Sales

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Hong Kong/China	43%	41%	40%	30%
Korea	16%	17%	20%	19%
Taiwan	16%	11%	11%	17%
Western Europe (excluding Germany)	9%	9%	10%	10%
Germany	5%	6%	6%	5%
Japan	4%	4%	5%	4%
Singapore	2%	4%	2%	3%
Other	1%	1%	1%	4%
Total foreign revenue.	96%	93%	95%	92%

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Product Sales

Sales of the Company s TOPSwitch and TinySwitch products accounted for 77% and 90% of net revenues from product sales for the three months ended September 30, 2007 and 2006, respectively, and 83% and 89% of net revenues from product sales for the nine months ended September 30, 2007 and 2006, respectively. TOPSwitch products include TOPSwitch, TOPSwitch-II, TOPSwitch-FX, TOPSwitch-GX and TOPSwitch-HX. TinySwitch products include TinySwitch, TinySwitch-II, TinySwitch-III, TinySwitch-PK and PeakSwitch. Sales of the Company s Linkswitch product accounted for 21% and 9% of net revenues from product sales for the three months ended September 30, 2007 and 2006, respectively, and 15% and 9% of net revenues from product sales for the nine months ended September 30, 2007 and 2006, respectively. The remaining 2% and 1% of net product sales in the three months ended September 30, 2007 and 2006, respectively, and the remaining 2% of net product sales in both the nine months ended September 30, 2007 and 2006, was comprised primarily of sales of the Company s DPA-Switch products.

7. EARNINGS PER SHARE:

Basic earnings per share are calculated by dividing net income by the weighted-average shares of common stock outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted-average shares of common stock and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares included in this calculation consist of dilutive shares issuable upon the exercise of outstanding common stock options, as computed using the treasury stock method.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Basic earnings per share:				
Net income	$ 6,753	$ 2,661	$ 20,036	$ 6,388
Weighted average common shares	28,789	28,650	28,708	29,192
Basic earnings per share	$ 0.23	$ 0.09	$ 0.70	$ 0.22
Diluted earnings per share:				
Net income	$ 6,753	$ 2,661	$ 20,036	$ 6,388
Weighted average common shares	28,789	28,650	28,708	29,192
Effect of dilutive securities:				
Stock options	2,467	1,182	2,196	1,695
Employee stock purchase plan	86		83	
Diluted weighted average common shares	31,342	29,832	30,987	30,887
Diluted earnings per share	$ 0.22	$ 0.09	$ 0.65	$ 0.21

Options to purchase 2,547,115 and 5,260,244 shares of the Company s common stock outstanding for the three month periods ended September 30, 2007 and 2006, respectively, and options to purchase 2,918,933 and 3,579,907 shares of the Company s common stock outstanding for the nine month periods ended September 30, 2007 and 2006, respectively, were not included in the computation of diluted earnings per share for the periods then ended because the exercise prices of the options to purchase shares of the Company s common stock were greater than the average market price of the Company s common stock during those periods and, therefore, their effect would have been antidilutive.

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. PROVISION FOR INCOME TAXES:

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the provisions of SFAS 109, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries. The Company s estimated effective tax rates for the three and nine months ended September 30, 2007 were 18% and 20%, respectively. The difference between the statutory rate of 35% and the Company s effective tax rate for the three and nine months ended September 30, 2007 was due primarily to the beneficial impact of international sales which are subject to lower tax rates, and the favorable effects of research and development tax credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees. The difference between the expected federal statutory rate of 35% and the Company s effective tax rates of approximately 4% and 8%, for the three and nine-month periods ended September 30, 2006, respectively, was primarily due to the beneficial impact of international sales subject to lower tax rates, lower taxable income recorded in higher tax rate jurisdictions due to increased expenses incurred in connection with the Company s investigation into its historical stock option practices and the resulting restatement of its financial statements, and research and development credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees.

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). The Company s liability for unrecognized tax benefits related to tax positions taken in prior periods is $13.2 million excluding interest. Upon adoption of FIN 48, there was an adjustment made to retained earnings of $1.04 million. Additionally, the Company has recorded the $13.2 million of FIN 48 liabilities as follows: reclassified $12.2 million from current taxes payable to non-current taxes payable and decreased $1.0 million of current taxes payable and decreased non-current deferred tax asset by $1.0 million.

Upon adoption of FIN 48, the Company s policy to include interest and penalties related to gross unrecognized tax benefits within its provision for income taxes did not change. As of September 30, 2007, the Company had accrued $0.9 million for payment of such interest and penalties, which is classified as non-current taxes payable. Interest and penalties included in the Company s provision for income taxes were $0.1 million in the three months ended September 30, 2007.

The Company s total unrecognized tax benefits as of January 1, 2007 and September 30, 2007 were $13.2 million and $15.7 million, respectively. Also, the Company s total unrecognized tax benefits, if recognized, would affect its tax provision by $13.2 million and $15.7 million as of January 1, 2007 and September 30, 2007.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. The Company s 2002 2006 tax years remain subject to examination by the IRS for U.S. federal tax purposes. Currently, the Company s returns are under examination by the IRS for its 2002 and 2003 tax years. There could be a significant change in the Company s uncertain tax benefits depending on the outcome of the current IRS audit; however, the Company believes that it is not reasonably possible that a settlement will be reached with the IRS within the next 12 months, and therefore is currently unable to estimate the likely outcome.

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

The Company addressed the implications of Section 409A of the Internal Revenue Code by adjusting the exercise price of stock options deemed by the Company to have been granted at a discount from their fair market value. This resulted from the Company s determination that the measurement date for those options differed from the original date used as the measurement date for those options. Section 409A would have imposed significant additional taxes to the

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company s employees on stock options granted with an exercise price lower than the fair market value on the date of grant that vest after December 31, 2004. The Internal Revenue Service has issued transition rules under Section 409A that allows for a correction, or cure, for options subject to Section 409A. The Company has allowed its current and former executive officers to amend their options to effect such a cure in 2006, and in the third quarter of 2007, the Company offered its employees who held outstanding options the opportunity to effect a cure of all affected stock options. In connection with this cure, the Company will make cash bonus payments in an aggregate amount of approximately $0.8 million in 2008 to non-officer employees, which was reflected in accrued payroll and related expenses in the Company s condensed consolidated balance sheet. The total bonus of $0.8 million was allocated between stock-based compensation expense ($0.4 million) and additional paid in capital ($0.4 million) in accordance with SFAS 123R. The stock-based compensation expense is included in cost of revenues and operating expenses in the accompanying statement of income for the quarter ended September 30, 2007.

9. INDEMNIFICATIONS:

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

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of September 30, 2007. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

10. COMMITMENTS AND CONTINGENCIES

From time to time the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. See note 11 below. In accordance with SFAS No. 5, *Accounting for Contingencies*, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

11. LEGAL PROCEEDINGS:

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (System General), a Taiwanese company, and its U.S. subsidiary. The complaint alleges that certain integrated circuits produced by System General infringed and continue to infringe certain of its patents. The Company seeks, among other things, an order enjoining System General from infringing its patents and an award for damages resulting from the alleged infringement. On June 10, 2005, in response to the initiation of the U.S. International Trade Commission (ITC) investigation (discussed below), the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay. On December 6, 2006, System General filed a notice of appeal of the ITC decision as discussed below. In response, and by agreement of the parties, the District Court renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination.

On May 9, 2005, the Company filed a Complaint with the ITC under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337. The Company filed a supplement to the complaint on May 24, 2005. The Company alleged infringement of certain of its patents pertaining to

pulse width modulation (PWM) integrated circuit devices. The Commission instituted an investigation on June 8, 2005 in response to the Company s complaint. Systems General Corporation filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. The

POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (ALJ) from January 18 to January 24, 2006. The ALJ s initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. On June 30, 2006 the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing Systems General PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing System General chip. The U.S. Customs Service is authorized to enforce the exclusion order which is now in full effect. On December 6, 2006 System General filed a notice of appeal of the ITC decision. Briefing has been completed, and oral argument is currently scheduled to be heard by the U.S. Court of Appeals for the Federal Circuit on November 9, 2007.

On October 20, 2004, The Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as Fairchild) in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four Power Integrations patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $33,981,781 in damages. Although the jury awarded damages, and the Company will request the damages to be enhanced in view of the jury s finding on willfulness, at this stage of the proceedings the Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company s consolidated financial statements as a result of the damages award. Fairchild raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in our favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild has stated that it intends to submit further materials on the issue of enforceability along with various other post-trial motions, and the Court will address those issues along with our motions seeking increased damages and an injunction, in the coming months.

On April 11, 2006, Fairchild Semiconductor Corporation and Intersil Corporation filed a patent infringement lawsuit against the Company in the U.S. District Court for the Eastern District of Texas. The complaint asserts that the Company infringed on an old Intersil patent that Fairchild recently secured exclusive rights to assert against the Company but Fairchild and Intersil did not identify any specific products they believe infringe the patent. Fairchild and Intersil s lawsuit is flawed because both Fairchild and Intersil lack standing to sue the Company and it is also duplicative of a portion of the Company s suit against Fairchild in Delaware, and the Company therefore filed a motion addressing both issues. The Texas Court granted the Company s motion to transfer the case to Delaware on March 6, 2007, and the case has been transferred to Delaware and assigned to Judge Farnan, the presiding judge in the Fairchild case discussed above. The Delaware Court held a status conference on August 2, 2007 and scheduled a trial for September 8, 2008, but there have been no further developments in the case. The Company continues to believe Fairchild s case should be dismissed for lack of standing, the parties have briefed the issue, and the Court held a hearing on October 5, 2007 and took the matter under advisement. The Company does not expect Fairchild s suit to have any impact on its lawsuit against Fairchild.

On June 14, 2007, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against Shanghai SIM-BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. subsidiary, BCD Semiconductor Corporation (referred to collectively as BCD). The complaint alleged that certain integrated circuits produced by BCD infringe certain of the Company s patents, seeking, among other things, an order enjoining BCD from infringing its patents and an award for damages resulting from the alleged infringement. The Company voluntarily dismissed the California case against BCD on October 15, 2007 and filed a substantially identical complaint against BCD in the United States District Court for the District of Delaware on October 15, 2007. BCD has not yet answered the complaint.

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of Power Integrations, against certain of Power Integrations current and former executives and members of its board of directors relating to the Company s historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco s counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. On August 3, 2007, plaintiffs filed an amended consolidated complaint. The amended consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of Power Integrations shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The amended consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. The parties are in settlement negotiations and, in light of recent progress, have requested that the Court suspend all deadlines while the parties attempt to complete and document a final settlement.

On May 26, 2006, Stanley Banko, an alleged shareholder, filed a derivative complaint in the Superior Court of California, Santa Clara County, purportedly on behalf of Power Integrations, against certain of the Company s current and former executives and members of Power Integrations board of directors relating to its historical stock option granting practices. On May 30, 2006, Joan Campbell, also an alleged shareholder, filed a derivative suit in the Superior Court of California, Santa Clara County, making the identical allegations asserted in the Banko lawsuit. On June 30, 2006, pursuant to a stipulation by the parties, the Court consolidated the two cases into a single proceeding and required plaintiffs to file an amended, consolidated complaint. Plaintiffs filed their consolidated complaint on August 14, 2006, in which plaintiffs named additional officers and former officers and KPMG LLP, Power Integrations former auditor, as new defendants. The consolidated complaint alleges, among other things, that the defendants caused or allowed Power Integrations executives to manipulate their stock option grant dates, that defendants improperly backdated stock option grants, and that costs associated with the stock option grants were not properly recorded in Power Integrations financial statements. The complaint asserts claims for, among other things, insider trading, breach of fiduciary duty, gross mismanagement and unjust enrichment. The parties are in settlement negotiations and, in light of recent progress, have requested that the Court suspend all deadlines while the parties attempt to complete and document a final settlement.

On May 23, 2006, the U.S. Attorney s Office for the Northern District of California, or DOJ, issued a grand jury subpoena to the Company directing that it produce documents relating to the granting of stock options from 1995 through the present. Since that time, the government has made a number of requests for the Company to voluntarily produce documents relating to, among other things, the Company s stock option practices. In addition, the government has been conducting voluntary interviews of certain current and former officers and employees. The Company believes it is cooperating fully with the DOJ and has stated its intent to continue to do so. The SEC was also conducting an investigation, but the Company has recently been informed by the staff of the SEC that they have terminated the investigation and are not recommending enforcement action be taken against it.

The Internal Revenue Service, or IRS, is conducting an audit of the Company s 2002 and 2003 tax returns. The IRS has issued a number of Notices of Proposed Adjustment to these returns. Among other things, the IRS has challenged several aspects of the Company s research and development cost-sharing arrangement, which was put into place on November 1, 2003. While the Company has agreed to some of the adjustments proposed by the IRS, it disputes other proposed adjustments.

There can be no assurance that the Company will prevail in its litigation with System General, Fairchild or BCD. This litigation, whether or not determined in the Company s favor or settled, will be costly and will divert the efforts and attention of the Company s management and technical personnel from normal business operations, potentially causing a material adverse effect on its business, financial condition and operating results. In addition, the Company is unable to predict the outcome of the other legal proceedings described above. Adverse determinations in litigation could result in monetary losses, the loss of the Company s proprietary rights, subject the Company to significant liabilities, require the Company to seek licenses from third parties or prevent the Company from licensing its technology, any of which could have a material adverse effect on the Company s business, financial condition and operating results.

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POWER INTEGRATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. RECENT ACCOUNTING PRONOUNCEMENTS:

In June 2007, the FASB ratified Emerging Issues Task Force (EITF) 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards*, or EITF 06-11. EITF 06-11 requires that the tax benefits of dividends on unvested share-based payments be recognized in equity and be reclassified from additional paid-in capital to the income statement when the related award is forfeited or no longer expected to vest. EITF 06-11 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007, and will be adopted by the Company in the first quarter of 2008. The Company is currently evaluating the impact of EITF 06-11.

In June 2007, the FASB ratified EITF 07-3, *Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities*, or EITF 07-3. EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007 and will be adopted by the Company in the first quarter of 2008. The Company is currently evaluating the effect that the adoption of EITF 07-3 will have on its consolidated results of operations and financial condition.

Effective January 1, 2007, the Company adopted the provisions of Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). The information on the implementation of FIN 48 is set forth in Note 8. There were no additional changes to the recent accounting pronouncements that were disclosed in the Company s Form 10-K for the year ended December 31, 2006.

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

The following management s discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, as well as with our management s discussion and analysis of our financial condition and results of operations contained in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A Risk Factors and elsewhere in this report.

Overview

We design, develop, manufacture and market proprietary, high-voltage analog integrated circuits (ICs) for use primarily in electronic power supplies, also known as switched-mode power supplies or switchers. Our ICs are used in AC-DC and DC-DC power supplies in a wide variety of electronic products, primarily in the consumer, communications, computer and industrial electronics markets. Accelerating the penetration of our ICs into this addressable market is our primary strategic objective.

Our ICs are purchased primarily by merchant power supply manufacturers who sell power supplies to OEMs, and, in some cases, by OEMs who design and build their own power supplies. In the nine months ended September 30, 2007, approximately 64% of our net product sales to these end customers were made through distributors of electronic components. Power supplies may be designed with our monolithic ICs, which combine a high-voltage transistor with low-voltage control circuitry, or with a number of competing alternatives. These alternatives include other monolithic and hybrid ICs, pulse width modulation (PWM) controller ICs paired with discrete transistors, and legacy technologies that do not utilize ICs, such as line-frequency transformers and self-oscillating switchers using discrete components.

Our sales process involves significant effort to convince our customers to design their power supplies using our ICs as components. Competition for these design wins at our end customers is intense, as the power-supply industry is extremely price-sensitive. We attempt to differentiate our offerings from competing alternatives through innovation aimed at helping our customers minimize the total cost of their power supplies while meeting the performance specifications demanded by their end customers. Much of this innovation is embodied in the features and functionality of our ICs, as well as in various power-supply design techniques developed by us for use by our customers. Further, we attempt to minimize the cost of producing our ICs through continuous improvement of our proprietary manufacturing process as well as other manufacturing efficiencies.

We employ a variety of methods for marketing and selling our products in an effort to accelerate the penetration of our addressable markets. We employ a staff of sales personnel and field applications engineers around the world, and have increased the size of this staff considerably over the past several years. In order to assist our customers in designing power supplies with our ICs, we offer a wide range of technical documentation as well as design-support tools and services. These include our PI Expert design software, which we offer free of charge, and our transformer sample service. We also continue to introduce more advanced products that make our solutions more cost-effective and easier for designers to use.

We believe that the increasing importance of energy-efficiency as a design criterion for power supplies could help accelerate the rate of adoption of our technology by the power-supply industry, and represents an important opportunity for us to increase the penetration rate of our products. This trend is predominantly the result of the emergence of energy-efficiency standards that encourage, or in some cases mandate, the design of more energy-efficient electronic products. Power supplies built with legacy technologies such as line-frequency transformers are often unable to meet these standards cost-effectively. Most notably, the California Energy Commission has introduced mandatory standards governing the energy efficiency of virtually all external power supplies; these standards became effective for all products in July of 2007. Other U.S. states, as well as Australia, have adopted virtually identical mandatory standards scheduled to take effect in 2007 and 2008. Further, in response to concerns about the energy inefficiency of incandescent lighting, various policymakers have enacted or proposed policies that could result in more rapid adoption of alternative lighting technologies such as light-emitting diodes (LEDs). We believe that this trend represents an additional market opportunity for us, since our ICs are used in power-supply circuitry to provide low-voltage DC power for LED light fixtures.

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Critical Accounting Policies and Estimates

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

Our critical accounting policies are as follows:

- revenue recognition;
- stock-based compensation;
- estimating sales returns and allowances;
- estimating distributor pricing credits;
- estimating allowance for doubtful accounts;
- estimating write-downs for excess and obsolete inventory; and
- income taxes.

Our critical accounting policies are important to the portrayal of our financial condition and results of operations, and require us to make judgments and estimates about matters that are inherently uncertain. A brief description of these critical accounting policies is set forth below. For more information regarding our accounting policies, see Note 2, Summary of Significant Accounting Policies, in our notes to condensed consolidated financial statements.

Revenue recognition

Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. Shipping terms to our international OEMs and merchant power supply manufacturers from our facility in California are delivered at frontier, commonly referred to as DAF. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of our product in that country. Shipping terms to our international OEMs and merchant power supply manufacturers shipped from our facility outside of the United States are EX Works (EXW), meaning that title to the product transfers to our customer upon shipment from our foreign warehouse. Shipments to the Americas OEMs and merchant power supply manufacturers are FOB-point of origin meaning that revenue is recognized upon shipment, which is when the title is passed to the customer.

Historically, between one-half and two-thirds of our total sales have been made to distributors pursuant to agreements that allow certain rights of return on our products held by these distributors. As a result of these rights, we defer the recognition of revenue and the costs of revenues derived from sales to distributors until such distributors resell our products to their customers. We determine the amounts to defer based on the level of actual inventory on hand at our distributors as well as inventory that is in transit to them. The gross profit that is deferred as a result of this policy is reflected as deferred income on sales to distributors in the accompanying condensed consolidated balance sheets.

Stock-based compensation

Effective January 1, 2006, we adopted SFAS 123R which requires the measurement and recognition of compensation expense for share-based payment awards. We estimate the fair value of employee stock options and employee stock purchase rights under our Employee Stock Purchase Plan (ESPP shares) on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model requires us to estimate the expected terms of awards, expected stock price volatility, dividend rate, and the risk-free interest rate. These estimates, some of which are highly subjective, greatly affect the fair value of each employee stock option and ESPP share. We calculate our estimate of expected volatility for both stock options and ESPP shares using a weighted-average of our historical stock price volatility and the implied volatility of our shares. We monitor the assumptions used to compute the fair value of our stock-based

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awards, and we will revise our assumptions as appropriate. In the event that we later determine that assumptions used to compute the fair value of our stock-based awards are inaccurate, or if we change our assumptions significantly in future periods, stock-based compensation expense and, therefore, our results of operations, could be materially impacted.

Estimating sales returns and allowances

Net revenues consist primarily of product revenues reduced by estimated sales returns and allowances. To estimate sales returns and allowances, we analyze, both when we initially establish the reserve and then each quarter when we review the adequacy of the reserve, the following factors: historical returns, current economic trends, levels of inventories of our products held by our distributor customers, and changes in customer demand and acceptance of our products. This reserve represents a reserve of the gross margin on estimated future returns and is reflected as a reduction to accounts receivable in the accompanying condensed consolidated balance sheets. Increases to the reserve are recorded as a reduction to net revenues equal to the expected customer credit memo, and a corresponding credit is made to cost of revenues equal to the estimated cost of the product to be returned. The net difference, or gross margin, is recorded as an addition to the reserve. Because the reserve for sales returns and allowances is based on our judgments and estimates, particularly as to future customer demand and level of acceptance of our products, our reserves may not be adequate to cover actual sales returns and other allowances. If our reserves are not adequate, our future net revenues and cost of revenues could be adversely affected.

Estimating distributor pricing credits

Historically, between one-half and two-thirds of our total sales have been made to distributors. Frequently, distributors need a cost lower than our standard sales price in order to win business. After the distributor ships product to its customer, the distributor submits a ship and debit claim to us in order to adjust its cost from the standard price to the approved lower price. After verification by us, a credit memo is issued to the distributor to adjust the sell-in price from the standard distribution price to the pre-approved lower price. We maintain a reserve for these credits that appears as a reduction to accounts receivable in our condensed consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in our net revenues. To establish the adequacy of our reserves, we analyze historical ship and debit amounts and levels of inventory in the distributor channels. If our reserves are not adequate, our net revenues could be adversely affected.

From time to time we reduce our distribution list prices. We give our distributors protection against these price declines in the form of credits on products they hold in inventory. These credits are referred to as price protection. Since we do not recognize revenue until the distributor sells the product to its customers, we generally do not need to provide reserves for price protection. However, in rare instances we must consider price protection in the analysis of reserve requirements, as there may be a timing gap between a price decline and the issuance of price protection credits. If a price protection reserve is required, we will maintain a reserve for these credits that appears as a reduction to accounts receivable in our condensed consolidated balance sheets. Any increase in the reserve results in a corresponding reduction in our net revenues. We analyze distribution price declines and levels of inventory in the distributor channels in determining the reserve levels required. If our reserves are not adequate, our net revenues could be adversely affected.

Estimating allowance for doubtful accounts

We maintain an allowance for losses we may incur as a result of our customers inability to make required payments. Any increase in the allowance for doubtful accounts results in a corresponding increase in our general and administrative expenses. In establishing this allowance, and in evaluating the adequacy of the allowance for doubtful accounts each quarter, we analyze historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms. If the financial condition of one or more of our customers deteriorates, resulting in their inability to make payments, or if we otherwise underestimate the losses we incur as a result of our customers inability to pay us, we could be required to increase our allowance for doubtful accounts which could adversely affect our operating results.

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Estimating write-downs for excess and obsolete inventory

When evaluating the adequacy of our valuation adjustments for excess and obsolete inventory, we identify excess and obsolete products and also analyze historical usage, forecasted production based on demand forecasts, current economic trends, and historical write-offs**.** This write-down is reflected as a reduction to inventory in the condensed consolidated balance sheets, and an increase in cost of revenues. If actual market conditions are less favorable than our assumptions, we may be required to take additional write-downs, which could adversely impact our cost of revenues and operating results.

Income taxes

Current income tax expense is an estimate of taxes payable or refundable in the current fiscal year based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences and carry-forwards that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. We recognize valuation allowances to reduce any deferred tax assets to the amount that we estimate will be more likely than not realized based on available evidence and management judgment. We limit the deferred tax assets recognized related to certain of our officer s compensation to amounts that we estimate will be deductible in future periods based upon Internal Revenue Code Section 162(m). As of September 30, 2007, we had not recorded any valuation allowance. In the event that we determine, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, we would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial position.

In July 2006, FASB issued FIN 48*,* which creates a single model to address accounting for uncertainty in tax positions by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the tax matter) that a tax position is more likely than not to be sustained on examination by a taxing authority. The second step, measurement, is only considered after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with the taxing authority or upon the expiration of the statute of limitations. The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are subject to change as a result of changes in fiscal policy, changes in legislation, evolution of regulations and court rulings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially to reverse previously recorded tax liabilities.

Results of Operations

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

	Percentage of Total Net Revenues for Three Months Ended September 30,		**Percentage of Total Net Revenues for Nine Months Ended September 30,**	
	2007	**2006**	**2007**	**2006**
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	47.0	45.8	45.5	45.1
Gross profit	53.0	54.2	54.5	54.9
Operating expenses:				
Research and development	13.4	14.3	13.3	15.0
Sales and marketing	14.0	14.3	14.1	15.7
General and administrative	13.0	23.0	13.3	22.1

Total operating expenses	40.4	51.6	40.7	52.8
Income from operations	12.6	2.6	13.8	2.1
Total other income	3.9	3.6	4.3	3.6
Income before provision for income taxes	16.5	6.2	18.1	5.7
Provision for income taxes	2.9	0.2	3.6	0.4
Net income	13.6%	6.0%	14.5%	5.3%

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Comparison of the Three Months and Nine Months Ended September 30, 2007 and 2006

Net revenues. Net revenues for the three months ended September 30, 2007 were $49.8 million compared to $44.4 million for the three months ended September 30, 2006, an increase of $5.4 million, or 12%. Net revenues for the nine months ended September 30, 2007 were $138.4 million compared to $121.1 million for the comparable period of 2006, an increase of $17.3 million or 14%. The increase in both the three and nine months ended September 30, 2007 was driven by increased penetration of our products across all of our major end markets, comprised of a variety of power-supply applications including cellphone chargers, desktop computers, consumer appliances and a range of industrial applications. The increase in net revenues was driven largely by sales of our Linkswitch products, which are targeted primarily at replacing linear power supplies, as well as sales of our TinySwitch-III products, which serve a wide range of power-supply applications. Our increase in revenue was partially offset for the three and nine month periods by reduced revenue from one of our end-customers in the cell phone market. This end-customer purchased a competing product from a competitor, which we believe is infringing on three of our patents. We are currently undertaking patent litigation against this competitor as described in Part II, Item 1, Legal Proceedings, of this Form 10-Q.

Revenue mix by product family for the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, was as follows:

	Three Months Ended		Nine Months Ended	
Product Family	**September 30, 2007**	**September 30, 2006**	**September 30, 2007**	**September 30, 2006**
TinySwitch	51%	54%	54%	52%
TOPSwitch	26%	36%	29%	37%
LinkSwitch	21%	9%	15%	9%
DPA-Switch	2%	1%	2%	2%

Approximate revenue mix by end markets served for the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006 was as follows:

	Three Months Ended		Nine Months Ended	
End Market	**September 30, 2007**	**September 30, 2006**	**September 30, 2007**	**September 30, 2006**
Consumer	29%	31%	30%	32%
Communication	26%	25%	27%	27%
Computer	23%	22%	21%	19%
Industrial	15%	15%	15%	15%
Other	7%	7%	7%	7%

International sales, which consist of sales outside of the Americas based on ship to customer locations, were $47.6 million in the third quarter of 2007 compared to $41.2 million for the same period in 2006, an increase of $6.4 million, or 16%. International sales represented 96% of net revenues compared to 93% in the three months ended September 30, 2007 and 2006, respectively. International sales were $131.3 million for the nine months ended September 30, 2007 compared to $111.8 million for the same period in 2006, an increase of $19.5 million, or 17%. International sales represented 95% of net revenues compared to 92% in the nine months ended September 30, 2007 and 2006, respectively.

Although the power supplies using our products are distributed to end markets worldwide, most of these power supplies are manufactured in Asia. As a result, sales to this region were 81% and 77% of our sales for the three months ended September 30, 2007 and 2006, respectively, and 79% and 77% of our sales for the nine months ended September 30, 2007 and 2006, respectively. The increase in sales to Asia as a percentage of revenues was driven primarily by the increase in sales of our LinkSwitch products to customers in the Asia region. We expect international sales, and sales to Asian customers in particular, to continue to account for a large portion of our net revenues.

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Net product sales for the third quarter of 2007 were divided 61% to distributors and 39% to OEMs and power supply merchants, compared to 62% to distributors and 38% to OEMs and power supply merchants for the third quarter of 2006. For the nine months ended September 30, 2007, net product sales were divided 63% to distributors and 37% to OEMs and power supply merchants, compared to 63% to distributors and 37% to OEMs and power supply merchants for the same period in 2006. One customer, a distributor of our products, accounted for 24% and 26% of net revenues in the three months ended September 30, 2007 and 2006, respectively, and 25% and 21% of net revenues for the nine months ended September 30, 2007 and 2006, respectively. No other customer accounted for 10% or more of our net revenues in the periods mentioned.

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 our foundries, as well as assembly, packaging and testing of our products by sub-contractors, plus internal labor and overhead costs associated with the testing of wafers and packaged components. Gross profit was $26.4 million, or 53% of net revenues, for the three months ended September 30, 2007, compared to $24.0 million, or 54% of net revenues, for the three months ended September 30, 2006. The increase in gross profits for the three months ended September 30, 2007 compared to the same period in 2006, in absolute dollars, was driven primarily by increased sales related to certain recent high-volume design wins for cellphone and smart-phone chargers, video game consoles and a number of other applications,. The decrease in our gross profit as a percentage of revenue for the same periods mentioned above, was due primarily to higher volume business in certain price-sensitive end markets where margins are inherently lower, such as cell phone chargers, DVD players and LCD monitors. Gross profit for the nine months ended September 30, 2007 and 2006 was $75.5 million compared to $66.5 million, respectively, or 55% of net revenues for both periods.

Research and development expenses. Research and development (R&D) expenses consist primarily of employee-related expenses (including stock-based compensation), expensed engineering material and facility costs associated with the development of new processes and new products. We also expense prototype wafers and mask sets related to new products as research and development costs until new products are released to production. Research and development expenses for the third quarter of 2007 were $6.7 million, or 13% of net revenues, compared to $6.3 million or 14% of net revenues in the same period in 2006. Research and development expenses for the nine months ended September 30, 2007 were $18.5 million, or 13% of net revenues, compared to $18.2 million or 15% of net revenues in the same period a year prior.

The increase in the three-month period was driven primarily by higher stock-based compensation and related expenses. The increase quarter over quarter was approximately $0.3 million, in part resulting from the granting of partially vested employee stock options to new hires and existing employees, which occurred in August of 2007, after our common stock was relisted on the NASDAQ. We incurred additional expense related to bonuses accrued to compensate employees for the correction of stock options subject to section 409A of the Internal Revenue Code. The increase was also due to increased payroll and related expenses due to increased headcount, and employee option exercises, which increased payroll taxes. The increase was slightly offset by a decrease in expensed equipment in the three months ended September 30, 2007; in the third quarter of 2006 we cancelled a previously capitalized software project, resulting in the write-off of capitalized project costs in September of 2006. The increase in R&D expenses in the nine months ended September 30, 2007 compared to the same period in 2006 was due primarily to the above-mentioned increase in payroll and related expenses as a result of increased headcount, in addition to merit increases for existing employees. This increase was partially offset by lower stock-based compensation expense, as we did not issue stock options while our common stock was delisted from the NASDAQ, resulting in lower stock-based compensation expense in the first nine months of 2007, compared to the same period in 2006. We do not expect research and development expenses to fluctuate significantly for the remainder of 2007, but these expenses may change as a percentage of our net revenues.

Sales and marketing expenses. Sales and marketing expenses consist primarily of employee-related expenses (including stock-based compensation), commissions to sales representatives, facilities expenses including expenses associated with our regional sales offices and support offices, and field application engineering costs. Sales and marketing expenses were $7.0 million for the third quarter of 2007, compared to $6.3 million for the same period in 2006, representing 14% of net revenues for both periods. Sales and marketing expenses for the nine months ended September 30, 2007 were $19.5 million, or 14% of net revenues, compared to $19.1 million, or 16% of net revenues, for the same period in 2006.

The increase in sales and marketing expenses in the three months ended September 30, 2007, was due primarily to increased payroll and related expenses due to increased headcount, and employee option exercises, which increased payroll taxes. Additionally, we incurred expenses as a result of granting partially vested employee stock options to new hires and existing employees, which occurred in August of 2007, after our common stock was relisted on the NASDAQ. We incurred additional expenses related to bonuses accrued to compensate employees for the correction of stock options subject to section 409A of the Internal Revenue Code. The increase in the nine months ended September 30, 2007 was due primarily to the increase in payroll and related expenses, and travel and related expenses as a result of increased headcount; additionally, merit increases were given to existing employees. This increase was partially offset by lower stock-based compensation expense, as we did not issue stock options while our common stock was delisted from the NASDAQ, resulting in lower stock-based compensation expense in the first nine months of 2007, compared to the same period in 2006. We expect quarterly sales and marketing expenses to be comparable to the third-quarter of 2007 for the remainder of 2007, but these expenses may fluctuate as a percentage of our net revenues.

General and administrative expenses. General and administrative expenses consist primarily of employee-related expenses (including stock-based compensation) for administration, finance, human resources and general management, as well as consulting fees, outside services, legal fees and fees for audit and tax services. For the quarter ended September 30, 2007, general and administrative expenses were $6.5 million, or 13% of net revenues, compared to $10.2 million, or 23% of net revenues, in the same period in 2006. For the nine months ended September 30, 2007, general and administrative expenses were $18.4 million, or 13% of net revenues, compared to $26.7 million, or 22% of net revenues, in the same period in 2006.

The decreases for both the three and nine month periods were driven primarily by lower professional fees associated with the conclusion of our internal investigation of our practices for granting and accounting for stock options, and the related restatement of our financial statements, in the first part of 2007. These expenses totaled $1.7 million and $5.0 million for the three- and nine-month periods ended September 30, 2007, compared to $4.7 million and $10.7 million for the same periods in 2006. In addition, professional fees related to our ongoing patent litigation decreased. Expenses for patent litigation in the three and nine months ended September 30, 2007, were $1.1 million and $3.2 million compared to $1.8 million and $5.5 million in the comparable periods in 2006. Adding to the decrease in the nine months ended September 30, 2007 compared to the same period in 2006, we had lower stock-based compensation expense, as we did not issue stock options while our common stock was delisted from the NASDAQ, resulting in lower stock-based compensation expense in the first nine months of 2007. We expect our general and administrative expenses to continue to decrease for the remainder of 2007 as the restatement-related expenses subside; however, these expenses may fluctuate as a percentage of our net revenues.

Other income, net. Other income, net, for the third quarter of 2007 was $1.9 million compared to $1.6 million for the same period in 2006. For the nine months ended September 30, 2007, other income, net, was $5.9 million compared to $4.4 million for the same period in 2006. Other income consists primarily of interest income earned on short-term and long-term investments. In the three and nine months ended September 30, 2007 the increase in other income is attributable to higher interest rates as well as increased cash and investments. In the nine months ended September 30, 2007, the increase is also attributable to a $0.7 million reimbursement for a directors and officers liability insurance claim received in the second quarter of 2007.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes. The provision for income taxes was $1.4 million for the quarter ended September 30, 2007, compared to $0.1 million for the quarter ended September 30, 2006. The provision for income taxes was $5.0 million for the nine months ended September 30, 2007, compared to $0.5 million for the same period in 2006. Our estimated effective tax rates for the three and nine months ended September 30, 2007 were approximately 18% and 20%, respectively. The difference between the expected statutory rate of 35% and our effective tax rates for the three and nine months ended September 30, 2007 was due primarily to international sales which are subject to lower tax rates, and the favorable effects of research and development tax credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees. The difference between the expected statutory rate of 35% and our effective tax rates for the three and nine months ended September 30, 2006, which were 4% and 8%, respectively, was due primarily to international sales which are subject to lower tax rates, lower taxable income in higher tax rate jurisdictions due to expenses related to our investigation of historical stock option practices and the resulting restatements of our prior financial statements, and the favorable effects of research and development tax credits, partially offset by permanent differences related to SFAS 123R stock option expense for foreign employees.

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Liquidity and Capital Resources

As of September 30, 2007, we had $178.0 million in cash, cash equivalents and short-term and long-term investments, including $1.3 million of restricted cash, an increase of approximately $45.3 million from December 31, 2006. On October 26, 2006, we entered into a security agreement with the Union Bank of California, whereby we agreed to maintain $1.3 million in an interest bearing certificate of deposit with the bank. This balance is classified as restricted cash on our condensed consolidated balance sheets. The purpose of this agreement is to secure commercial letters of credit which we provide to Matsushita Electric Industrial Co., Ltd., or MEI, prior to the shipment of wafers to us, and also to our workers compensation insurance carrier as part of our insurance program. This agreement remains in effect until cancellation of our letters of credit. As of September 30, 2007, there were outstanding letters of credit totaling approximately $1.2 million.

As of September 30, 2007, we had working capital, defined as current assets less current liabilities, of approximately $189.1 million, an increase of approximately $55.5 million from December 31, 2006. Our operating activities generated $44.4 million in cash for the nine months ended September 30, 2007. This cash flow from operations was primarily the result of our net income of $20.0 million, which was reduced by non-cash expenses for stock-based compensation and depreciation and amortization, totaling $9.8 million and $6.0 million, respectively. In addition, inventories decreased by $8.3 million over the nine-month period, driven primarily by strong product sales in the third quarter. The positive cash impact of the decrease in inventories was partially offset by higher accounts receivable, which increased by $4.1 million primarily reflecting growth in our sales.

Net cash used in investing activities in the nine months ended September 30, 2007 was $14.8 million. Our investing activities consisted of net purchases of $7.8 million of held-to-maturity investments and purchases of property and equipment of $7.0 million. Our net cash used in investing activities in the nine months ended September 30, 2006 was $17.2 million. Our investing activities consisted of net purchases of $6.2 million of held-to-maturity investments, purchases of property and equipment of $7.9 million, and the acquisition of a technology license from our foundry OKI, for $3.0 million, to be utilized in the production of our products. The acquired license from OKI, and other licenses and patent rights are reported net of accumulated amortization on our condensed consolidated balance sheet. We amortize the cost of intangible assets (licenses and patents) over the term of the acquired license or patent rights, which ranges from five to twelve years.

Our net cash provided by financing activities for the nine months ended September 30, 2007 was $7.8 million, and consisted primarily of net proceeds of $7.7 million from the issuance of common stock through the exercise of stock options. Our net cash used in financing activities for the nine months ended September 30, 2006 was $13.9 million, and consisted primarily of the use of $19.6 million of cash, including fees, for the repurchase of approximately 1.1 million shares of our common stock, offset in part by net proceeds of $5.6 million from the issuance of common stock through the exercise of stock options and purchases through our employee stock purchase plan.

On October 19, 2005, we announced that our board of directors had authorized the repurchase of up to $25 million of our common stock. From inception of the stock repurchase program in October 2005 through June 30, 2006, we had repurchased 1.3 million shares for approximately $25 million, the total amount authorized by the board of directors. No shares have been repurchased since June 2006.

As of September 30, 2007, our total amount of unrecognized tax benefits was $15.7 million, and it was classified as deferred tax assets and long-term income taxes payable in our condensed consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next twelve months.

During the first nine months of 2007, a significant portion of our cash flow was generated by our operations. If our operating results were to deteriorate as a result of a decrease in customer demand for our products, or severe pricing pressures from our customers or our competitors, or for other reasons, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, or seek financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

Recent Accounting Pronouncements

In June 2007, the FASB ratified Emerging Issues Task Force (EITF) 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards*, or EITF 06-11. EITF 06-11 requires that the tax benefits of dividends on unvested share-based payments be recognized in equity and be reclassified from additional paid-in capital to the income statement when the related award is forfeited or no longer expected to vest. EITF 06-11 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007, and will be adopted by us in the first quarter of 2008. We are currently evaluating the impact of EITF 06-11.

In June 2007, the FASB ratified EITF 07-3, *Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities*, or EITF 07-3. EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007 and will be adopted by us in the first quarter of 2008. We are currently evaluating the effect that the adoption of EITF 07-3 will have on our consolidated results of operations and financial condition.

Effective January 1, 2007, we adopted the provisions of FIN 48. The information on the implementation of FIN 48 is set forth in Part I, Note 8 of this report under the heading Income Taxes . There were no additional changes to recent accounting standards as disclosed in our Form 10-K for the year ended December 31, 2006.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS.

There has not been a material change in our exposure to interest rate and foreign currency risks from that described in our 2006 Annual Report on Form 10-K.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months but not longer than twelve months from the balance sheet date are classified as short-term investments. Investments in highly liquid financial instruments with maturities greater than twelve months from the balance sheet date are classified as long-term investments. We do not use derivative financial instruments in our investment portfolio to manage our interest rate risk, foreign currency risk, or for any other purpose. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we 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. We do not hold any instruments for trading purposes. At September 30, 2007 and December 31, 2006, we held primarily cash equivalents and short-term investments, with fixed interest rates and with maturity dates of less than twelve months.

Foreign Currency Exchange Risk. We transact business in various foreign countries. Our primary foreign currency cash flows are in Asia and Western Europe. Currently, we do not employ a foreign currency hedge program utilizing foreign currency forward exchange contracts; however, the contract prices to purchase wafers from MEI and OKI are denominated in Japanese yen and both agreements allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Nevertheless, 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. We maintain a Japanese yen account with a U.S. bank in an amount that generally approximates expected payments to our wafer suppliers in Japan. This practice acts to minimize the impact of changes in the yen. In addition, the yen and the U.S. dollar historically have not fluctuated greatly from year to year; and typically we have not had a significant amount of foreign currency at risk. In light of these facts, we do not believe we have a material foreign currency exchange risk.

ITEM 4. CONTROLS AND PROCEDURES.

Limitation on Effectiveness of Controls

It should be noted that any control system, no matter how well designed and operated, can provide only reasonable assurance to the tested objectives. The design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated

goals under all potential future conditions, regardless of how remote. The inherent limitations in any control system include the realities that judgments related to decision-making can be faulty, and that reduced effectiveness in controls can occur because of simple errors or mistakes. Due to the inherent limitations in a cost-effective control system, misstatements due to error may occur and may not be detected.

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report, or the Evaluation Date.

The purpose of this evaluation is to determine if, as of the Evaluation Date, our disclosure controls and procedures were designed and operating effectively to provide reasonable assurance that the information relating to our financial statements and footnote disclosures, required in our Exchange Act filings (1) was recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (2) was accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Based on this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were not effective as of September 30, 2007, as a result of three material weaknesses that existed in our internal control over financial reporting. The material weaknesses, as described in the following paragraphs, are related to accounting for stock grants, income tax accounting and the application of generally accepted accounting principles to material non-routine transactions.

Control Activities Related to Accounting for Stock-Based Compensation

As of September 30, 2007, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of APB 25, SFAS No. 123 and SFAS No. 123(R), which replaced APB 25 and SFAS 123 effective January 1, 2006.

In the course of our investigation of our stock option granting practices, which we conducted in 2006, we determined that our controls were not adequate to ensure that our stock option grants had a correctly recorded grant date, the first date on which the number of shares that an individual employee was entitled to receive and the exercise price were both known with finality. This included not having sufficient controls in place to ensure that option grants received the required corporate approvals. Moreover, we did not have sufficient controls in place to properly account for stock option grants that had modifications in key terms.

This lack of internal controls and procedures led to incorrect application of APB 25 for periods prior to January 1, 2006, which provided that compensation expense relative to our employee stock options should be measured based on the intrinsic value of stock options granted. For periods after December 31, 2005, this lack of internal controls and procedures led to incorrect application of SFAS 123R, which provides for share-based compensation expense based on fair value. Based on our investigation, we concluded that original measurement dates on certain stock option grants could not be relied upon for accounting purposes and that the appropriate charges for such stock option grants and for stock option grants where key terms were potentially modified had not been properly recorded. As a result we did not correctly account for stock-based compensation expense for certain stock option grants.

In connection with errors that resulted from this material weakness, we recorded non-cash charges for stock-based compensation and the related payroll and income tax effects in prior periods, and, we restated our historical consolidated financial statements in our December 31, 2005 Form 10-K for each of the fiscal years ended 1998 through 2004, and each of the first three quarters of the year ended December 31, 2005, and for each of the four quarters of the year ended December 31, 2004.

Additionally, subsequent to the filing of our Annual Report on Form 10-K for the year ended December 31, 2004, we determined that we erroneously applied certain aspects of SFAS No. 123. As a result, we had to make certain changes in the assumptions we used to calculate pro forma net income, and the footnote disclosures under the provisions of SFAS No. 123. Accordingly, we determined that our controls were not adequate to ensure that the assumptions we used were accurate.

As of September 30, 2007, this material weakness had not been remediated. Therefore, we did not have sufficient controls in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of SFAS No. 123R, which replaced APB 25 and SFAS 123 in 2006.

Control Activities Relating to Income Tax Accounting

As of September 30, 2007, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the accounting and review of our income taxes payable, deferred income tax assets and liabilities, and the related tax provision.

In 2006, we determined that we did not have appropriate staffing resources to perform our tax accounting functions. Specifically, there was a failure to consistently apply generally accepted accounting principles in determining our income taxes payable, deferred income tax assets and liabilities, and the related tax provision. In the course of reviewing these errors, we determined that our controls were not adequate to ensure the completeness and accuracy of the tax provision in accordance with generally accepted accounting principles. As of September 30, 2007, this material weakness had not been remediated.

Control Activities Relating to the Application of Generally Accepted Accounting Principles to Non-Routine Transactions

As of September 30, 2007, we did not have sufficient controls and procedures in place to cause us to have a remote or less than a remote likelihood that a material misstatement would be prevented or detected in the consolidated financial statements and related disclosures from the application of generally accepted accounting principles to material, non-routine, non-systematic transactions.

This third material weakness resulted from an adjustment of $1.4 million of legal expenses we paid and assumed would be reimbursed under our Directors and Officers liability insurance policy. We originally recorded a receivable for this amount. After subsequent review, we determined that this was a gain contingency, as per SFAS No. 5, *Accounting for Contingencies,* specifically paragraph 179(a), and should not be recorded as a receivable at December 31, 2006, because to do so might be a recognition of a gain prior to its realization. Consequently we failed to appropriately apply generally accepted accounting principles to the accounting for this transaction and concluded that there was more than a remote likelihood that a material misstatement of our annual financial statements would not have been prevented or detected. As of September 30, 2007, this material weakness had not been remediated.

Changes in Internal Control over Financial Reporting

During the quarter ended September 30, 2007 and prior to, we have taken several steps to strengthen our disclosure controls and procedures and internal control over financial reporting. Specifically, we have implemented the following internal control improvements.

Changes Related to Stock-Based Compensation

Prior to the quarter ended September 30, 2007, we engaged the services of an external specialist in stock-based compensation to assist us in the accounting for stock-based compensation as per the requirements of SFAS No. 123R. In addition, we have engaged our corporate counsel to revise our policies and procedures surrounding the administration of our stock option grants to our employees.

Although this change in our controls and processes, along with others that we established prior to the beginning of 2007, related to the granting and accounting for stock options, management has not had the opportunity to complete their evaluation of the operating effectiveness of these controls. We only began granting employee stock options to new hires and existing employees in August 2007, when our common stock was relisted on the NASDAQ, and have not completed our testing and assessment as of the Evaluation Date.

Changes Related to Income Tax Accounting

To strengthen our processes related to tax accounting, management improved our process with the assistance of our third party tax accounting firm, by engaging, and seeking to further engage, more senior and qualified staff.

Although management has made changes to strengthen this area of tax accounting in the third quarter of 2007, the additional reviews will be tested in the fourth quarter of 2007 to ensure that these higher-level reviews will be successful to remediate this material weakness.

Changes Related to the Application of Generally Accepted Accounting Principles to Non-Routine Transactions

To strengthen our processes relating to the accounting for material, non-routine, non-systematic transactions in accordance with generally accepted accounting principles, we have documented and implemented a process to identify and research those items and engage technical expertise, if determined to be required, to provide reasonable assurance that the transactions are prepared in accordance with generally accepted accounting principles. Our policy requires the contemporaneous documentation and evaluation of complex and unusual transactions which are material either by the size or the nature of the transaction. In conjunction with this policy, we have implemented more rigorous controls for ensuring that those transactions which involve a significant level of management judgment or which by the nature of the transactions rise to a level requiring communication to the Audit Committee are, in fact, communicated to the Audit Committee on a timely basis.

Management began meeting on a quarterly basis in the second quarter of 2007 to discuss non-routine accounting transactions. This revised control will be tested in the fourth quarter of 2007 to ensure successful remediation of this material weakness.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On June 28, 2004, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (System General), a Taiwanese company, and its U.S. subsidiary. Our complaint alleges that certain integrated circuits produced by System General infringed and continue to infringe certain of our patents. We seek, among other things, an order enjoining System General from infringing our patents and an award for damages resulting from the alleged infringement. On June 10, 2005, in response to the initiation of the U.S. International Trade Commission (ITC) investigation (discussed below), the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay. On December 6, 2006, System General filed a notice of appeal of the ITC decision as discussed below. In response, and by agreement of the parties, the District Court renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination.

On May 9, 2005, we filed a Complaint with the ITC under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337. We filed a supplement to the complaint on May 24, 2005. We alleged infringement of certain of our patents pertaining to pulse width modulation (PWM) integrated circuit devices. The Commission instituted an investigation on June 8, 2005 in response to our complaint. Systems General Corporation filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. We subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge (ALJ) from January 18 to January 24, 2006. The ALJ s initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. On June 30, 2006 the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing Systems General PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing Systems General chip. The U.S. Customs Service is authorized to enforce the exclusion order which is now in full effect. On December 6, 2006 System General filed a notice of appeal of the ITC decision. Briefing has been completed, and oral argument is currently scheduled to be heard by the U.S. Court of Appeals for the Federal Circuit on November 9, 2007.

On October 20, 2004, we filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as Fairchild) in the United States District Court for the District of Delaware. In our complaint, we alleged that Fairchild has and is infringing four Power Integrations patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to us. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of us finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $33,981,781 in damages. Although the jury awarded damages, and we will request the damages to be enhanced in view of the jury s finding on willfulness, at this stage of the proceedings we cannot state the amount, if any, which might ultimately be recovered by us from Fairchild, and no benefits have been recorded in our consolidated financial statements as a result of the damages award. Fairchild raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in our favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild has stated that it intends to submit further materials on the issue of enforceability along with various other post-trial motions, and the Court will address those issues along with our motions seeking increased damages and an injunction, in the coming months.

On April 11, 2006, Fairchild Semiconductor Corporation and Intersil Corporation filed a patent infringement lawsuit against us the U.S. District Court for the Eastern District of Texas. The complaint asserts that we infringed on an old Intersil patent that Fairchild recently secured exclusive rights to assert against us but Fairchild and Intersil did not identify any specific products they believe infringe the patent. Fairchild and Intersil s lawsuit is flawed because both Fairchild and Intersil lack standing to sue us and it is also duplicative of a portion of our suit against Fairchild in Delaware, and we therefore filed a motion addressing both issues. The Texas Court granted our motion to transfer the case to Delaware on March 6, 2007, and the case has been transferred to Delaware and assigned to Judge Farnan, the presiding judge in the Fairchild case discussed above. The Delaware Court held a status conference on August 2, 2007 and scheduled a trial for September 8, 2008, but there have been no further developments in the case. We continue to believe Fairchild s case should be dismissed for lack of standing, the parties have briefed the issue, and the Court held a hearing on October 5, 2007 and took the matter under advisement. We do not expect Fairchild s suit to have any impact on our lawsuit against Fairchild.

On June 14, 2007, we filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against Shanghai SIM-BCD Semiconductor Manufacturing Limited, a Chinese company, and its U.S. subsidiary, BCD Semiconductor Corporation (referred to collectively as BCD). Our complaint alleged that certain integrated circuits produced by BCD infringe certain of our patents, seeking, among other things, an order enjoining BCD from infringing our patents and an award for damages resulting from the alleged infringement. We voluntarily dismissed the California case against BCD on October 15, 2007 and filed a substantially identical complaint against BCD in the United States District Court for the District of Delaware on October 15, 2007. BCD has not yet answered the complaint.

On April 25, 2006, Kimberly Quaco, an alleged shareholder, filed a derivative complaint in the United States District Court for the Northern District of California, purportedly on behalf of Power Integrations, against certain of Power Integrations current and former executives and members of our board of directors relating to our historical stock option granting practices. On August 1, 2006, Kathryn L. Champlin, another alleged shareholder, filed a similar derivative complaint in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On September 21, 2006, Christopher Deboskey, another alleged shareholder, filed a similar derivative suit in the United States District Court for the Northern District of California purportedly on behalf of Power Integrations. On November 30, 2006, Ms. Champlin voluntarily dismissed her suit. On December 18, 2006, the Court appointed Ms. Quaco s counsel as lead counsel and ordered that another purported shareholder, Mr. Geoffrey Wren, be substituted in as lead plaintiff. On January 17, 2007, the plaintiffs filed their consolidated complaint. On August 3, 2007, plaintiffs filed an amended consolidated complaint. The amended consolidated complaint alleges, among other things, that the defendants breached their fiduciary duties by improperly backdating stock option grants in violation of Power Integrations shareholder approved stock option plans, improperly recording and accounting for the backdated options, improperly taking tax deductions based on the backdated options, and disseminating false financial statements that improperly recorded the backdated option grants. The amended consolidated complaint asserts claims for, among other things, breach of fiduciary duty, unjust enrichment, and violations of Section 10(b) of the Securities Exchange Act of 1934. The parties are in settlement negotiations and, in light of recent progress, have requested that the Court suspend all deadlines while the parties attempt to complete and document a final settlement.

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On May 26, 2006, Stanley Banko, an alleged shareholder, filed a derivative complaint in the Superior Court of California, Santa Clara County, purportedly on behalf of Power Integrations, against certain of our current and former executives and members of Power Integrations board of directors relating to our historical stock option granting practices. On May 30, 2006, Joan Campbell, also an alleged shareholder, filed a derivative suit in the Superior Court of California, Santa Clara County, making the identical allegations asserted in the Banko lawsuit. On June 30, 2006, pursuant to a stipulation by the parties, the Court consolidated the two cases into a single proceeding and required plaintiffs to file an amended, consolidated complaint. Plaintiffs filed their consolidated complaint on August 14, 2006, in which plaintiffs named additional officers and former officers and KPMG LLP, Power Integrations former auditor, as new defendants. The consolidated complaint alleges, among other things, that the defendants caused or allowed Power Integrations executives to manipulate their stock option grant dates, that defendants improperly backdated stock option grants, and that costs associated with the stock option grants were not properly recorded in Power Integrations financial statements. The complaint asserts claims for, among other things, insider trading, breach of fiduciary duty, gross mismanagement and unjust enrichment. The parties are in settlement negotiations and, in light of recent progress, have requested that the Court suspend all deadlines while the parties attempt to complete and document a final settlement.

On May 23, 2006, the U.S. Attorney s Office for the Northern District of California, or DOJ, issued a grand jury subpoena to us directing that we produce documents relating to the granting of stock options from 1995 through the present. Since that time, the government has made a number of requests for us to voluntarily produce documents relating to, among other things, our stock option practices. In addition, the government has been conducting voluntary interviews of certain current and former officers and employees. We are cooperating fully with the DOJ and intend to continue to do so. The SEC was also conducting an investigation, but we have recently been informed by the staff of the SEC that they have terminated the investigation and are not recommending enforcement action be taken against us.

The Internal Revenue Service, or IRS, is conducting an audit of our 2002 and 2003 tax returns. The IRS has issued a number of Notices of Proposed Adjustment to these returns. Among other things, the IRS has challenged several aspects of our research and development cost-sharing arrangement, which was put into place on November 1, 2003. While we have agreed to some of the adjustments proposed by the IRS, we dispute other proposed adjustments.

There can be no assurance that we will prevail in our litigation with System General, Fairchild or BCD. This litigation, whether or not determined in our favor or settled, will be costly and will divert the efforts and attention of our management and technical personnel from normal business operations, potentially causing a material adverse effect on our business, financial condition and operating results. In addition, we are unable to predict the outcome of the other legal proceedings described above. Adverse determinations in litigation could result in monetary losses, the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from licensing our technology, any of which could have a material adverse effect on our business, financial condition and operating results.

ITEM 1A. RISK FACTORS

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. These risk factors have not changed substantively from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2006, except for those risk factors below designated by an asterisk (*). In addition, we deleted the risk relating to our common stock not being listed on NASDAQ, as it has been relisted.

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

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

- the volume and timing of orders received from customers;
- competitive pressures on selling prices;
- the demand for our products declining in the major end markets we serve;
- the inability to adequately protect or enforce our intellectual property rights;
- the volume and timing of orders placed by us with our wafer foundries and assembly subcontractors;
- we are being audited by the Internal Revenue Service, which is asserting that we owe additional taxes relating to a number of items;
- U.S. Department of Justice investigation and stockholder litigation related to our previous internal investigation of our practices related to stock option grants and the related restatement of our consolidated financial statements;
- continued impact of recently enacted changes in securities laws and regulations, including potential risks resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002;
- expenses we incur related to stock-based compensation may increase if we are required to change our assumptions used in the Black-Scholes model;
- expenses we are required to incur (or choose to incur) in connection with our litigation against Fairchild Semiconductor, System General Corporation, and BCD;
- fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen;
- the licensing of our intellectual property to one of our wafer foundries;
- the lengthy timing of our sales cycle;
- undetected defects and failures in meeting the exact specifications required by our products;
- reliance on international sales activities for a substantial portion of our net revenues;

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

the ability of our products to penetrate additional markets;

attraction and retention of qualified personnel in a competitive market;

changes in environmental laws and regulations; and

earthquakes, terrorists acts or other disasters.

**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 our business may suffer.* Our business is characterized by short-term customer orders and shipment schedules. Our customer base is highly concentrated, and a relatively small number of distributors, OEMs and merchant power supply manufacturers account for a significant portion of our revenues. Our top ten customers, including distributors, accounted for 63%, of our net revenues for the nine months ended September 30, 2007. The ordering patterns of some of our existing large customers have been unpredictable in the past and we expect that customer-ordering patterns will continue to be unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without 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.

Intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products. The high-voltage power supply industry is intensely competitive and characterized by significant price sensitivity. Our products face competition from alternative technologies, such as linear transformers, discrete switcher power supplies, and other integrated and hybrid solutions. If the price of competing solutions decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized go outside the cost-effective range of our products, some of these alternative technologies can be used more cost effectively. In addition, as our patents expire, our competitors could legally begin using the technology covered by the expired patents in their products, potentially increasing the performance of their products and/or decreasing the cost of their products, which may enable our competitors to compete more effectively. Our current patents may or may not inhibit our competitors from getting any benefit from an expired patent. One of our patents recently expired, and our remaining U.S. patents have expiration dates ranging from 2009 to 2026. We cannot assure 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 our major end markets, our net revenues will decrease. A limited number of applications of our products, such as cellphone chargers, standby power supplies for PCs, and power supplies for home appliances comprise a significant percentage of our net revenues. We expect that a significant level of our net revenues and operating results will continue to be dependent upon these applications in the near term. The demand for these products has been highly cyclical and has been impacted by economic downturns in the past. Any economic slowdown in the end markets that we serve could cause a slowdown in demand for our ICs. When our customers are not successful in maintaining high levels of demand for their products, their demand for our ICs decreases, which adversely affects our operating results. Any significant downturn in demand in these markets would cause our net revenues to decline and could cause the price of our stock to fall.

If we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability. Our success depends upon our ability to continue our technological innovation and protect our intellectual property, including patents, trade secrets, copyrights, and know-how. We are currently engaged in litigation to enforce our intellectual property rights, and associated expenses have been, and are expected to remain, material and have adversely affected our operating results. We cannot assure 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. Costly litigation may be necessary to enforce our intellectual property rights or to defend us against claimed infringement. The failure to obtain necessary licenses and other rights, and/or litigation arising out of infringement claims could cause us to lose market share and harm our business.

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As our patents expire, we will lose intellectual property protection previously afforded by those patents. Additionally, 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 limiting the protections applicable to our technology.

**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 may suffer*. We have supply arrangements for the production of wafers with Matsushita, OKI, Zfoundry and Epson. Our contracts with these suppliers expire in June 2010, April 2008, December 2009 and December 2010, respectively. Although certain aspects of our relationships with Matsushita, OKI, Zfoundry and Epson are contractual, many important aspects of these relationships depend on their continued cooperation. We cannot assure that we will continue to work successfully with Matsushita, OKI, ZFoundry and Epson in the future, and that the wafer foundries capacity will meet our needs. Additionally, one or more of these wafer foundries could seek an early termination of our wafer supply agreements. Any serious disruption in the supply of wafers from OKI, Matsushita, ZFoundry or Epson could harm our business. We estimate that it would take nine to 18 months from the time we identified an alternate manufacturing source to produce wafers with acceptable manufacturing yields in sufficient quantities to meet our needs.

Although we provide our foundries with rolling forecasts of our production requirements, their ability to provide wafers to us is ultimately limited by the available capacity of the wafer foundry. Any reduction in wafer foundry capacity available to us could require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions 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 independent foundries to produce wafers, and independent subcontractors to assemble and test finished products, at acceptable yields and to deliver them to us in a timely manner. The failure of the foundries 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 that, until recently, has been available from only one supplier. In December 2006, an alternative molding compound, made by a different supplier was qualified for use on our highest volume package type. These compounds and their specified processing conditions require a more exacting level of process control than normally required for standard IC packages. Unavailability of assembly materials or problems with the assembly process can materially adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

In addition, if prices for commodities used in our products increase significantly, raw materials costs of our suppliers would increase and could result in increased product costs our suppliers charge us. If we are not able to pass these costs on to our customers, this would have an adverse effect on our gross margins.

**We are subject to a U.S. Department of Justice investigation and stockholder litigation related to our recent internal investigation of our practices related to stock option grants and the related restatement of our consolidated financial statements*. The U.S. Department of Justice, or DOJ, is conducting an investigation related to our internal investigation of our practices related to stock option grants. The SEC was also conducting an investigation, but we have recently been informed by the staff of the SEC that they have terminated the investigation and are not recommending enforcement action be taken against us. In addition, three alleged shareholders of Power Integrations have filed derivative complaints in the United States District Court for the Northern District of California, and two alleged shareholders have filed derivative complaints in Superior Court of California, Santa Clara County, all purportedly on behalf of Power Integrations, against certain of our current and former executive officers and directors in connection with our option granting practices alleging, among other things, breaches of fiduciary duties and in the federal court cases violations of Section 10(b) of the Securities Exchange Act of 1934. The shareholder derivative suits are discussed in more detail in Part II, Item 1 of this Form 10-Q. The ongoing legal fees we are incurring in connection with these actions, and any fines that we may be required to pay in the event that the DOJ determines, as a result of its investigation, to bring any civil or other actions against us, or any attorneys fees that we may be required to pay as a result of the derivative suits, would have an adverse effect on our operating results. Further, these actions require a significant amount of our senior management s attention, which detracts from their ability to manage our company s business.

Recently enacted changes in securities laws and regulations, including potential risk resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002 will continue to impact our results. Complying with the requirements of the Sarbanes-Oxley Act of 2002 and NASDAQ s conditions for continued listing have imposed significant legal and financial compliance costs, and are expected to continue to impose significant costs and management burden on us. These new rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly qualified members to serve on our audit committee.

Additionally, we cannot be sure that we will be able to successfully remediate the currently reported material weaknesses in our system of internal controls. Our efforts to comply with Section 404 of the Sarbanes-Oxley Act and the related regulations regarding our required assessment of our internal controls over financial reporting and our external auditors attestation report on our management s assessment of our internal controls continues to require the commitment of significant financial and managerial resources.

Moreover, because these laws, regulations and standards promulgated by the Sarbanes-Oxley Act are subject to varying interpretations, their application in practice may evolve over time as new guidance becomes available. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

**Changes in assumptions used for our SFAS 123R calculation may increase our stock-based compensation expense.* We determine the value of stock options granted using the Black-Scholes model. This model requires that we make certain assumptions, including an assumption as to the volatility of our common stock price, and an estimate of our expected life of stock options. Historically we have established the volatility factor based both on the past trading of our common stock, as well as the trading in the market of options to purchase our common stock. Due to the delisting of our common stock on the NASDAQ Global Select Market, options in our common stock ceased to trade. However, we have continued to determine the volatility factor based in part upon past option trading history. Now that our common stock has been relisted on the NASDAQ Global Select Market, we expect options in our common stock to resume trading. If option trading does not resume, we may be required to establish the volatility factor for the Black-Scholes model based solely upon the historical trading of our common stock. If this were to occur, we believe this would result in substantially higher stock-based compensation expenses. Historically we have used the simplified method to calculate the expected life of stock option grants. This method assumes all options will be exercised midway between the vesting date and the contractual term of the option. In accordance with Staff Accounting Bulletin 107, or SAB 107, the simplified method may only be used until December 31, 2007. Beginning in January 2008 we intend to develop a new method based on our observations of employee option exercises. We will need to exercise judgment in deciding how best to stratify our employees into homogenous groups according to their exercise and post-vesting employment termination behaviors. In doing so, the life of stock option grants may change significantly, and therefore, may result in substantially higher stock-based compensation expenses. These changes in assumptions may have a material adverse effect on our operating results and could harm our stock price.

If we do not prevail in our litigation against Fairchild Semiconductor, System General, and BCD we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of proprietary rights. We are in patent litigation with each of Fairchild Semiconductor, System General Corp., and BCD Semiconductor Manufacturing Limited, and the outcome of this litigation is uncertain. The next phase of the Fairchild suit will determine whether or not our patents at issue in the suit are valid. One of the patents that is the subject of the litigation has recently expired. In addition, there is no assurance that we will be successful in obtaining financial damages or an injunction against all System General products or BCD products that infringe our patents. We have incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits. Thus, even if we are successful in these lawsuits, we will have incurred significant legal costs, potentially without any benefit which could have a material adverse effect on our business. Further, if we are not successful in the Fairchild lawsuit, our patents at issue in the suit may be determined invalid and we will not receive any damages, including the $34 million the jury awarded us in October 2006, nor will we have the intellectual property protection we currently believe is provided by these patents.

We are being audited by the Internal Revenue Service which is asserting that we owe additional taxes relating to a number of items, and if we are not successful in defending our position we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future. Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by

the IRS and state, local and foreign tax authorities. In connection with an IRS audit of our United States federal income tax returns for fiscal years 2002 and 2003, the IRS is asserting that we owe additional taxes relating to a number of items, the most significant of which is our research and development cost sharing arrangements with one of our subsidiaries. We disagree with the IRS s position; however, if we are not successful in defending our position, we could be required to pay additional taxes, penalties and interest for 2002 and 2003, as well as for subsequent years that are not currently under audit. Resolution of this matter could take considerable time, possibly years.

We believe the IRS position with respect to certain items for which it has proposed adjustments is inconsistent with applicable tax laws, and that we have meritorious defenses to our position with respect to these proposed adjustments. Accordingly, we intend to continue to challenge the IRS position on these matters vigorously. While we believe the IRS asserted position on these matters is not supported by applicable law, we may be required to make additional payments in order to resolve these matters. If the IRS determines that we owe additional taxes for these matters, our results of operations and financial condition would be materially and adversely affected.

Fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen, may impact our gross margin. The contract prices to purchase wafers from Matsushita and OKI are denominated in Japanese yen. The agreements with both vendors allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Nevertheless, 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.

**Matsushita has licenses to our technology, which it may use to our detriment.* Pursuant to a Technology Agreement with Matsushita, which expired in June 2005, Matsushita has the perpetual right to manufacture and sell products that incorporate our technology to Japanese companies worldwide and to subsidiaries of Japanese companies located in Asia. Matsushita does not have rights to utilize technology developed by us after June 2005, when the agreement expired. According to the expired Technology Agreement, we will continue to receive royalties on Matsushita s sales through June 2009 at a reduced rate. Royalty revenues were less than 1% of total net revenues for the nine months ended September 30, 2007 and for the year ended December 31, 2006. However, these royalties are substantially lower than the gross profit we receive on direct sales, and we cannot assure that Matsushita will not use the technology rights to continue to develop and market competing 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, can often require us to expend significant research and development and sales and marketing resources without any assurance of success. These significant research and development and sales and marketing resources 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 that we will continue to achieve design wins or that any design win will result in future revenues. If a customer decides at the design stage not to incorporate our products into its product, we may not have another opportunity for a design win with respect to that product for many months or years.

Our products must meet exacting specifications, and undetected defects and failures may occur which may cause customers to return or stop buying our products. Our customers generally establish demanding specifications for quality, performance and reliability, and our products must meet these specifications. 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 and customer expenses, delays in or cancellations or rescheduling of orders or shipments and product returns or discounts, any of which would harm our operating results.

**Our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks.* Sales to customers outside of the Americas account for, and have accounted for a large portion of our net revenues, including approximately 95% and 92% of our net revenues for the nine months ended September 30, 2007 and 2006, respectively. If our international sales declined and we were unable to increase domestic sales, our revenues would decline and our operating results would be harmed. International sales involve a number of risks to us, including:

- potential insolvency of international distributors and representatives;

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- 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;
- the burdens of complying with a variety of foreign and applicable U.S. Federal and state laws; and
- foreign-currency exchange risk.

Our failure to adequately address these risks could reduce our international sales and 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 cause the price of our products in foreign markets to rise, making our products more expensive relative to competing products priced in local currencies.

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

In addition, 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 that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Our failure, or our customers failure, to develop and introduce new products successfully and in a timely manner would harm our business. In addition, customers may defer or return orders for existing products in response to the introduction of new products. Although we maintain reserves for potential customer returns, we cannot assure that these reserves will be adequate.

If our products do not penetrate additional markets, our business will not grow as we expect. We believe that our future success depends in part upon our ability to penetrate additional markets for our products. We cannot assure that we will be able to overcome the marketing or technological challenges necessary to penetrate additional markets. 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.

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 analog design engineers and 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 could harm our business. In addition, if one or more of these individuals leaves our employ, and we are unable to quickly and efficiently replace those individuals with qualified personnel who can smoothly transition into their new roles, our business may suffer. 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.

Changes in environmental laws and regulations may increase our costs related to obsolete products in our existing inventory. Changing environmental regulations and the timetable to implement them continue to impact our customers demand for our products. As a result there could be an increase in our inventory obsolescence costs for products manufactured prior to our customers adoption of new regulations. Currently we have limited visibility into our customers strategies to implement these changing environmental regulations into their business. The inability to accurately determine our customers strategies could increase our inventory costs related to obsolescence.

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In the event of an earthquake, terrorist act or other disaster, our operations may be interrupted and our business would be harmed. Our principal executive offices and operating facilities situated near San Francisco, California, and most of our major suppliers, which are wafer foundries and assembly houses, are located in areas that have been subject to severe earthquakes. Many of our suppliers are also susceptible to other disasters such as tropical storms, typhoons or tsunamis. In the event of a disaster, we or one or more of our major suppliers may be temporarily unable to continue operations and may suffer significant property damage. Any interruption in our ability or that of our major suppliers to continue operations at our facilities could delay the development and shipment of our products.

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

We have adopted anti-takeover measures which may make it more difficult for a third party to acquire us. Our board of directors may issue up to 2,925,000 shares of preferred stock and determine the price, rights, preferences and privileges of those preferred 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 make 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 addition, we have entered into a rights agreement, commonly referred to as a poison pill, to guard against abusive hostile takeover tactics. Further, the anti-takeover provisions of Section 203 of the Delaware General Corporations Law apply to us. Our rights agreement and Section 203 of the Delaware General Corporations Law may discourage, delay or prevent a change in control of Power Integrations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On July 16, 2007, an employee of our company exercised an option to purchase 5,343 shares of Power Integrations common stock for an exercise price of $2.55. On July 30, 2007, an employee of our company exercised an option to purchase 270 shares of Power Integrations common stock for an exercise price of $2.55. The exercises of the options were made in reliance on Rule 701 promulgated under the Securities Act of 1933, as amended, as the options were granted prior to the initial public offering of Power Integrations common stock in reliance on Rule 701.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

POWER INTEGRATIONS, INC.

Date: November 8, 2007

By: /s/ RAFAEL TORRES
Rafael Torres
Chief Financial Officer (*Principal Financial and* Accounting Officer)

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Exhibit Number	Description
3.1	Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Annual Report on Form 10-K on March 16, 1999, SEC File No. 000-23441.)
3.2	Certificate of Amendment to Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.3 to our Annual Report on Form 10-K on March 22, 2002, SEC File No. 000-23441.)
3.3	Form of Certificate of Designation, Preferences and Rights of the Terms of the Series A Preferred Stock filed as Exhibit A to the Form of Rights Agreement between Power Integrations, Inc. and BankBoston N.A., dated February 24, 1999. (As filed with the SEC as Exhibit 1 to our Current Report on Form 8-K on March 12, 1999, SEC File No. 000-23441.)
3.4	Certificate of Amendment to Certificate of Incorporation. (As filed as Exhibit 3.1 to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.)
3.5	Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.2 to our Current Report on Form 8-K on November 9, 2007, SEC File No. 000-23441.)
4.1	Reference is made to Exhibits 3.1 to 3.4.
4.2	Fifth Amended and Restated Rights Agreement by and among Power Integrations, Inc. and certain of our investors, dated April 27, 1995. (As filed with the SEC as Exhibit 4.1 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441.)
4.3	Investor s Rights Agreement between Power Integrations, Inc. and Hambrecht & Quist Transition Capital, LLC, dated as of May 22, 1996. (As filed with the SEC as Exhibit 4.2 to our Registration Statement on Form S-1 on September 11, 1997, SEC File No. 000-23441.)
4.4	Rights Agreement between Power Integrations, Inc. and BankBoston N.A., dated as of February 24, 1999 (As filed with the SEC as Exhibit 1 to our Current Report on Form 8-K on March 12, 1999, SEC File No. 000-23441.)
4.5	Amendment to Rights Agreement between Power Integrations, Inc. and BankBoston N.A., dated as of October 9, 2001 (As filed with the SEC as Exhibit 4.3 to our Quarterly Report on Form 10-Q on November 9, 2001, SEC File No. 000-23441.)
10.1	2007 Executive Officer Cash Compensation Arrangements (As described in Item 5.02 of our Current Report on Form 8-K filed with the SEC on June 8, 2007, SEC File No. 000-23441.)
10.2	Letter agreement, dated as of August 31, 2007, between Power Integrations, Inc. and Derek Bell.
10.3	Amended and Restated Chief Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Balu Balakrishnan.
10.4	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Bruce Rouard.
10.5	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and John Tomlin.
10.6	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Cliff Walker.
10.7	Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Rafael Torres.
10.8	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Doug Bailey.
10.9	Amendment to Executive Officer Benefits Agreement, dated as of August 8, 2007, and entered into August 15, 2007, between Power Integrations, Inc. and Derek Bell.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**

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

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

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	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Cash settlements received for matured derivatives, net[1]	$ 13,705	$ 47,382	$ 21,156	$ 113,319
Cash settlements received for early terminations of derivatives, net[2]	4,234	—	4,234	

80,000

Cash settlements received for derivatives, net

$
17,939

$
47,382

$
25,390

$
193,319

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(1) The settlement amounts do not include premiums paid attributable to contracts that matured during the respective period.

(2) The settlement amount for the six months ended June 30, 2016 includes $4.0 million in deferred premiums that were settled net with the early terminated contracts from which they originated.

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The following table summarizes open positions as of June 30, 2017, and represents, as of such date, derivatives in place through December 2018 on annual production:

	Remaining year 2017	Year 2018
Oil positions:		
Puts:		
Hedged volume (Bbl)	529,000	2,616,875
Weighted-average price ($/Bbl)	$ 60.00	$ 54.01
Swaps:		
Hedged volume (Bbl)	1,012,000	—
Weighted-average price ($/Bbl)	$ 51.54	$ —
Collars:		
Hedged volume (Bbl)	1,913,600	4,088,000
Weighted-average floor price ($/Bbl)	$ 56.92	$ 41.43
Weighted-average ceiling price ($/Bbl)	$ 86.00	$ 60.00
Call Spreads:		
Hedged volume (Bbl)	1,324,800	—
Weighted-average short call price ($/Bbl)	$ 60.00	$ —
Weighted-average long call price ($/Bbl)	$ 97.22	$ —
Totals:		
Total volume hedged with floor price (Bbl)	3,454,600	6,704,875
Weighted-average floor price ($/Bbl)	$ 55.82	$ 46.34
Total volume hedged with ceiling price (Bbl)	2,925,600	4,088,000
Weighted-average ceiling price ($/Bbl)	$ 57.22	$ 60.00
NGL positions:		
Swaps - Ethane:		
Hedged volume (Bbl)	222,000	—
Weighted-average price ($/Bbl)	$ 11.24	$ —
Swaps - Propane:		
Hedged volume (Bbl)	187,500	—
Weighted-average price ($/Bbl)	$ 22.26	$ —
Natural gas positions:		
Puts:		
Hedged volume (MMBtu)	4,020,000	8,220,000
Weighted-average price ($/MMBtu)	$ 2.50	$ 2.50
Collars:		
Hedged volume (MMBtu)	9,586,400	15,585,500
Weighted-average floor price ($/MMBtu)	$ 2.86	$ 2.50
Weighted-average ceiling price ($/MMBtu)	$ 3.54	$ 3.35
Totals:		
Total volume hedged with floor price (MMBtu)	13,606,400	23,805,500
Weighted-average floor price ($/MMBtu)	$ 2.75	$ 2.50
Total volume hedged with ceiling price (MMBtu)	9,586,400	15,585,500
Weighted-average ceiling price ($/MMBtu)	$ 3.54	$ 3.35

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b. Balance sheet presentation

In accordance with the Company's standard practice, its derivatives are subject to counterparty netting under their governing agreements. The Company's oil, NGL and natural gas derivatives are presented on a net basis as "Derivatives" on the unaudited consolidated balance sheets. See Note 8.a for a summary of the fair value of derivatives on a gross basis.

By using derivatives to hedge exposures to changes in commodity prices, the Company exposes itself to credit risk and market risk. For the Company, market risk is the exposure to changes in the market price of oil, NGL and natural gas, which are subject to fluctuations from a variety of factors, including changes in supply and demand. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Company, thereby creating credit risk. The Company's counterparties are participants in the Senior Secured Credit Facility, which is secured by the Company's oil, NGL and natural gas reserves; therefore, the Company is not required to post any collateral. The Company does not require collateral from its derivative counterparties. The Company minimizes the credit risk in derivatives by: (i) limiting its exposure to any single counterparty, (ii) entering into derivatives only with counterparties that meet the Company's minimum credit quality standard or have a guarantee from an affiliate that meets the Company's minimum credit quality standard and (iii) monitoring the creditworthiness of the Company's counterparties on an ongoing basis.

Note 8—Fair value measurements

The Company accounts for its oil, NGL and natural gas derivatives at fair value. The fair value of derivatives is determined utilizing pricing models for similar instruments. The models use a variety of techniques to arrive at fair value, including quotes and pricing analysis. Inputs to the pricing models include publicly available prices and forward curves generated from a compilation of data gathered from third parties.

The Company has categorized its assets and liabilities measured at fair value, based on the priority of inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

Assets and liabilities recorded at fair value on the unaudited consolidated balance sheets are categorized based on inputs to the valuation techniques as follows:

Level 1—	Assets and liabilities recorded at fair value for which values are based on unadjusted quoted prices for identical assets or liabilities in an active market that management has the ability to access. Active markets are considered to be those in which transactions for the assets or liabilities occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
Level 2—	Assets and liabilities recorded at fair value for which values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the assets or liabilities. Substantially all of these inputs are observable in the marketplace throughout the full term of the price risk management instrument and can be derived from observable data or supported by observable levels at which transactions are executed in the marketplace.
Level 3—	Assets and liabilities recorded at fair value for which values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Unobservable inputs are not corroborated by market data. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the asset or liability.

When the inputs used to measure fair value fall within different levels of the hierarchy in a liquid environment, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company conducts a review of fair value hierarchy classifications on an annual basis. Changes in the observability of valuation inputs may result in a reclassification for certain financial

assets or liabilities. Transfers between fair value hierarchy levels are recognized and reported in the period in which the transfer occurred. No transfers between fair value hierarchy levels occurred during the six months ended June 30, 2017 or 2016.

a. Fair value measurement on a recurring basis

The following tables summarize the Company's fair value hierarchy by commodity on a gross basis and the net presentation on the unaudited consolidated balance sheets for derivative assets and liabilities measured at fair value on a recurring basis as of the periods presented:

(in thousands)	Level 1	Level 2	Level 3	Total gross fair value	Amounts offset	Net fair value presented on the unaudited consolidated balance sheets
As of June 30, 2017:						
Assets						
Current:						
Oil derivatives	$ —	$46,492	$—	$46,492	$ (323)	$ 46,169
NGL derivatives	—	110	—	110	(678)	(568)
Natural gas derivatives	—	4,452	—	4,452	(1,577)	2,875
Oil deferred premiums	—	—	—	—	(4,637)	(4,637)
Natural gas deferred premiums	—	—	—	—	(854)	(854)
Noncurrent:						
Oil derivatives	$ —	$14,712	$—	$14,712	$ —	$ 14,712
NGL derivatives	—	—	—	—	—	—
Natural gas derivatives	—	2,822	—	2,822	—	2,822
Oil deferred premiums	—	—	—	—	(3,068)	(3,068)
Natural gas deferred premiums	—	—	—	—	(1,659)	(1,659)
Liabilities						
Current:						
Oil derivatives	$ —	$(204)	$—	$(204)	$ 323	$ 119
NGL derivatives	—	(678)	—	(678)	678	—
Natural gas derivatives	—	(13)	—	(13)	1,577	1,564
Oil deferred premiums	—	—	(4,637)	(4,637)	4,637	—
Natural gas deferred premiums	—	—	(3,190)	(3,190)	854	(2,336)
Noncurrent:						
Oil derivatives	$ —	$—	$—	$—	$ —	$ —
NGL derivatives	—	—	—	—	—	—
Natural gas derivatives	—	—	—	—	—	—
Oil deferred premiums	—	—	(3,068)	(3,068)	3,068	—
Natural gas deferred premiums	—	—	(1,659)	(1,659)	1,659	—
Net derivative position	$ —	$67,693	$(12,554)	$55,139	$ —	$ 55,139

Table of Contents Laredo Petroleum, Inc.
Condensed notes to the consolidated financial statements
(Unaudited)

(in thousands)	Level 1	Level 2	Level 3	Total gross fair value	Amounts offset	Net fair value presented on the unaudited consolidated balance sheets
As of December 31, 2016:						
Assets						
Current:						
Oil derivatives	$ —	$22,527	$—	$22,527	$ —	$ 22,527
NGL derivatives	—	—	—	—	—	—
Natural gas derivatives	—	270	—	270	(270)	—
Oil deferred premiums	—	—	—	—	(1,580)	(1,580)
Natural gas deferred premiums	—	—	—	—	—	—
Noncurrent:						
Oil derivatives	$ —	$8,718	$—	$8,718	$ —	$ 8,718
NGL derivatives	—	—	—	—	—	—
Natural gas derivatives	—	1,377	—	1,377	(1,377)	—
Oil deferred premiums	—	—	—	—	—	—
Natural gas deferred premiums	—	—	—	—	—	—
Liabilities						
Current:						
Oil derivatives	$ —	$(9,789)	$—	$(9,789)	$ —	$ (9,789)
NGL derivatives	—	(2,803)	—	(2,803)	—	(2,803)
Natural gas derivatives	—	(3,639)	—	(3,639)	270	(3,369)
Oil deferred premiums	—	—	(3,569)	(3,569)	1,580	(1,989)
Natural gas deferred premiums	—	—	(3,043)	(3,043)	—	(3,043)
Noncurrent:						
Oil derivatives	$ —	$(4,552)	$—	$(4,552)	$ —	$ (4,552)
NGL derivatives	—	—	—	—	—	—
Natural gas derivatives	—	(133)	—	(133)	1,377	1,244
Oil deferred premiums	—	—	—	—	—	—
Natural gas deferred premiums	—	—	(2,386)	(2,386)	—	(2,386)
Net derivative position	$ —	$11,976	$(8,998)	$2,978	$ —	$ 2,978

These items are included as "Derivatives" on the unaudited consolidated balance sheets. Significant Level 2 assumptions associated with the calculation of discounted cash flows used in the mark-to-market analysis of derivatives include each derivative contract's corresponding commodity index price, appropriate risk-adjusted discount rates and other relevant data.

The Company's deferred premiums associated with its derivative contracts are categorized as Level 3, as the Company utilizes a net present value calculation to determine the valuation. They are considered to be measured on a recurring basis as the derivative contracts they derive from are measured on a recurring basis. As derivative contracts containing deferred premiums are entered into, the Company discounts the associated deferred premium to its net present value at the contract trade date, using the Senior Secured Credit Facility rate at the trade date (historical input rates range from 1.69% to 3.56%), and then records the change in net present value to interest expense over the period from trade until

the final settlement date at the end of the contract. After this initial valuation, the net present value of each deferred premium is not adjusted; therefore, significant increases (decreases) in the Senior Secured Credit Facility rate would result in a significantly lower (higher) fair value measurement for each new contract entered into that contained a deferred premium; however, the valuation for the deferred premiums already recorded would remain unaffected. While the Company believes the sources utilized to arrive at the fair value estimates are reliable, different sources or methods could have yielded different fair value estimates; therefore, on a quarterly basis, the valuation is compared to counterparty valuations and a third-party valuation of the deferred premiums for reasonableness.

The following table presents actual cash payments required for deferred premiums as of June 30, 2017 for the periods presented:

(in thousands)	June 30, 2017
Remaining 2017	$2,888
2018	9,375
2019	535
Total	$12,798

A summary of the changes in net assets classified as Level 3 measurements for the periods presented are as follows:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Balance of Level 3 at beginning of period	$(13,025)	$(13,054)	$(8,998)	$(14,619)
Change in net present value of derivative deferred premiums	(70)	(61)	(111)	(133)
Total purchases and settlements:				
Purchases	(905)	(1,960)	(6,998)	(6,072)
Settlements[1]	1,446	2,413	3,553	8,162
Balance of Level 3 at end of period	$(12,554)	$(12,662)	$(12,554)	$(12,662)

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(1) The amount for the six months ended June 30, 2016 includes $3.9 million that represents the present value of deferred premiums settled in the Company's restructuring upon their early termination.

b. Fair value measurement on a nonrecurring basis

The Company accounts for the impairment of long-lived assets, if any, at fair value on a nonrecurring basis. For purposes of fair value measurement, it was determined that the impairment of long-lived assets is classified as Level 3, based on the use of internally developed cash flow models. No impairments of long-lived assets were recorded during the six months ended June 30, 2017 or 2016.

The Company accounts for the impairment of inventory, if any, at lower of cost or NRV on a nonrecurring basis. For purposes of fair value measurement, it was determined that the impairment of inventory is classified as Level 2, based on the use of a replacement cost approach. See Note 2.i for discussion of the Company's inventory impairments recorded during the three and six months ended June 30, 2016. No impairments of inventory were recorded during the six months ended June 30, 2017.

The accounting policies for impairment of oil and natural gas properties are discussed in Note 2.g. Significant inputs included in the calculation of discounted cash flows used in the impairment analysis include the Company's estimate of operating and development costs, anticipated production of evaluated reserves and other relevant data. See Note 2.g for discussion of the Company's full cost ceiling impairment recorded during the six months ended June 30, 2016. There were no full cost ceiling impairments recorded during the six months ended June 30, 2017.

The Company accounts for acquisitions of evaluated and unevaluated oil and natural gas properties under the acquisition method of accounting. Accordingly, the Company conducts assessments of net assets acquired and recognizes amounts for identifiable assets acquired and liabilities assumed at the estimated acquisition date fair values, while transaction costs associated with the acquisitions are expensed as incurred.

The Company makes various assumptions in estimating the fair values of assets acquired and liabilities assumed. The most significant assumptions relate to the estimated fair value of evaluated and unevaluated oil and natural gas properties. The fair value of these properties are measured using a discounted cash flow model that converts future cash flows to a single discounted amount. Significant inputs to the valuation include estimates of: (i) forecasted oil, NGL and natural gas reserve quantities; (ii) future commodity strip prices as of the closing dates adjusted for transportation and regional price differentials; (iii) forecasted ad valorem taxes, production taxes, income taxes,

general and administrative expenses, operating expenses and development costs; and (iv) a peer group weighted-average cost of capital rate subject to additional project-specific risk factors. To compensate for the inherent risk of estimating the value of the unevaluated properties, the discounted future net revenues of proved undeveloped and probable reserves are reduced by additional reserve adjustment factors. These assumptions represent

Level 3 inputs under the fair value hierarchy. No acquisitions of evaluated and unevaluated oil and natural gas properties were recorded during the six months ended June 30, 2017 or 2016.

Note 9—Net income (loss) per common share

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per common share reflects the potential dilution of non-vested performance share awards, non-vested restricted stock awards and outstanding stock option awards. For the three and six months ended June 30, 2016, all of these potentially dilutive items were anti-dilutive due to the Company's net loss and, therefore, were excluded from the calculation of diluted net loss per common share. The effect of the Company's outstanding stock option awards, with the exception of the options granted in 2016, was excluded from the calculation of diluted net income per common share for the three and six months ended June 30, 2017. The inclusion of these options would be anti-dilutive due to the following: (i) utilizing the treasury stock method, the sum of the assumed proceeds exceeded the average stock prices during the respective periods for the outstanding stock option awards granted in 2015 and (ii) the exercise prices were greater than the average market prices during the respective periods for the outstanding stock option awards granted in 2012, 2013, 2014 and 2017.

The following is the calculation of basic and diluted weighted-average common shares outstanding and net income (loss) per common share for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands, except for per share data)	2017	2016	2017	2016
Net income (loss) (numerator):				
Net income (loss)—basic and diluted	$61,110	$(71,432)	$129,386	$(251,803)
Weighted-average common shares outstanding (denominator):				
Basic	239,231	217,564	238,870	214,562
Non-vested performance share awards(1)	4,666	—	4,488	—
Non-vested restricted stock awards(2)	419	—	896	—
Outstanding stock option awards(2)	101	—	131	—
Diluted	244,417	217,564	244,385	214,562
Net income (loss) per common share:				
Basic	$0.26	$(0.33)	$0.54	$(1.17)
Diluted	$0.25	$(0.33)	$0.53	$(1.17)

(1) For the three and six months ended June 30, 2017, the dilutive effect of non-vested performance share awards with performance periods that have not yet ended was calculated utilizing the Company's total shareholder return ("TSR") from the beginning of each performance share awards' respective performance period to June 30, 2017 in comparison to the TSR of the peers specified in each performance share awards' respective agreement. See Note 5.c for additional discussion of the Company's performance share awards.

(2) For the three and six months ended June 30, 2017, the dilutive effects of the non-vested restricted stock awards and the outstanding stock option awards were calculated utilizing the treasury stock method. See Notes 5.a and 5.b for additional discussion of the Company's restricted stock awards and stock option awards, respectively.

Note 10—Credit risk

The Company's oil, NGL and natural gas sales are made to a variety of purchasers, including intrastate and interstate pipelines or their marketing affiliates and independent marketing companies. The Company's joint operations accounts receivable are from a number of oil and natural gas companies, partnerships, individuals and others who own interests in the oil and natural gas properties operated by the Company. The Company's sales of purchased oil are made to one customer. Management believes that any credit risk imposed by a concentration in the oil and natural gas industry is offset by the creditworthiness of the Company's customer base and industry partners. The Company routinely assesses

the recoverability of all material trade and other receivables to determine collectability.

The Company uses derivatives to hedge its exposure to oil, NGL and natural gas price volatility. These transactions expose the Company to potential credit risk from its counterparties. In accordance with the Company's standard practice, its derivatives are subject to counterparty netting under agreements governing such derivatives; therefore, the credit risk associated with its derivative counterparties is somewhat mitigated. See Notes 2.e, 7 and 8.a for additional information regarding the Company's derivatives.

Note 11—Commitments and contingencies

a. Litigation

From time to time the Company is involved in legal proceedings and/or may be subject to industry rulings that could bring rise to claims in the ordinary course of business. Except with regard to the specific litigation noted below, the Company has concluded that the likelihood is remote that the ultimate resolution of any such pending litigation or pending claims will be material or have a material adverse effect on the Company's business, financial position, results of operations or liquidity.

On May 3, 2017, Shell Trading (US) Company ("Shell") filed an Original Petition and Request for Disclosure in the District Court of Harris County, Texas, alleging that the crude oil purchase agreement entered into between Shell and Laredo effective October 1, 2016 does not reflect the compensation for Shell that Shell believes was previously agreed to by the parties due to a drafting mistake. Shell seeks reformation of one clause of the crude oil purchase agreement on the grounds of alleged mutual mistake or, in the alternative, unilateral mistake; an award of the amounts Shell alleges it should have been or should be paid under the agreement; court costs and attorneys' fees. The Company does not believe there was a drafting mistake made in the crude oil purchase agreement. The Company believes it has substantive defenses and intends to vigorously defend its position. The Company is unable to determine the outcome or estimate its ultimate exposure, if any, to this litigation at this time.

b. Drilling contracts

The Company has committed to several drilling contracts with a third party to facilitate the Company's drilling plans. One of these contracts is for a term of multiple months and contains an early termination clause that requires the Company to potentially pay a penalty to the third party should the Company cease drilling efforts. This penalty would negatively impact the Company's financial statements upon early contract termination. There were no penalties incurred for early contract termination for either of the six months ended June 30, 2017 or 2016. The future commitment of $2.3 million as of June 30, 2017 is not recorded in the accompanying unaudited consolidated balance sheets. Management does not currently anticipate the early termination of this contract in 2017.

c. Firm sale and transportation commitments

The Company has committed to deliver for sale or transportation fixed volumes of product under certain contractual arrangements that specify the delivery of a fixed and determinable quantity. If not fulfilled, the Company is subject to deficiency payments. These commitments are normal and customary for the Company's business. In certain instances, the Company has used spot market purchases to meet its commitments in certain locations or due to favorable pricing. Management anticipates continuing this practice in the future. The Company incurred deficiency payments of $0.5 million and $0.6 million during the three and six months ended June 30, 2017, respectively, which are reported on the unaudited consolidated statements of operations in the "Other operating expenses" line item. There were no deficiency payments during the six months ended June 30, 2016. Future commitments of $381.8 million as of June 30, 2017 are not recorded in the accompanying unaudited consolidated balance sheets.

d. Federal and state regulations

Oil and natural gas exploration, production and related operations are subject to extensive federal and state laws, rules and regulations. Failure to comply with these laws, rules and regulations can result in substantial penalties. The regulatory burden on the oil and natural gas industry increases the cost of doing business and affects profitability. The

Company believes that it is in compliance with currently applicable federal and state regulations related to oil and natural gas exploration and production, and that compliance with the current regulations will not have a material adverse impact on the financial position or results of operations of the Company. These rules and regulations are frequently amended or reinterpreted; therefore, the Company is unable to predict the future cost or impact of complying with these regulations.

Note 12—Related parties

a. Medallion

The following table summarizes items included in the unaudited consolidated balance sheets related to Medallion as of the dates presented:

(in thousands)	June 30, 2017	December 31, 2016
Accounts receivable, net	$ 59	$ —
Accrued capital expenditures	$ 379	$ 586
Other current liabilities	$ 102	$ 118

b. Archrock Partners, L.P.

The Company has a compression arrangement with affiliates of Archrock Partners, L.P., formerly Exterran Partners L.P. ("Archrock"). One of Laredo's directors is on the board of directors of Archrock GP LLC, an affiliate of Archrock.

As of December 31, 2016, amounts included in accounts payable from Archrock in the unaudited consolidated balance sheets totaled $0.2 million. No such amounts were included as of June 30, 2017.

The following table summarizes the lease operating expenses related to Archrock included in the unaudited consolidated statements of operations for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Lease operating expenses	$ 232	$ 526	$ 656	$ 1,001

The following table summarizes the capital expenditures related to Archrock included in the unaudited consolidated statements of cash flows for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Capital expenditures:				
Midstream service assets	$ 108	$ —	$ 108	$ 20

Note 13—Segments

The Company operates in two business segments: (i) exploration and production and (ii) midstream and marketing. The exploration and production segment is engaged in the acquisition, exploration and development of oil and natural gas properties. The midstream and marketing segment provides Laredo's exploration and production segment and third parties with products and services that need to be delivered by midstream infrastructure, including oil and liquids-rich natural gas gathering services as well as rig fuel, natural gas lift and water delivery and takeaway.

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The following table presents selected financial information, for the periods presented, regarding the Company's operating segments on a stand-alone basis and the consolidation and elimination entries necessary to arrive at the information for the Company on a consolidated basis:

(in thousands)	Exploration and production	Midstream and marketing	Eliminations	Consolidated company
Three months ended June 30, 2017:				
Revenues:				
Oil, NGL and natural gas sales	$142,288	$825	$(1,276)	$141,837
Midstream service revenues	—	18,104	(15,401)	2,703
Sales of purchased oil	—	42,461	—	42,461
Total revenues	142,288	61,390	(16,677)	187,001
Costs and expenses:				
Lease operating expenses, including production and ad valorem taxes	31,993	—	(3,417)	28,576
Midstream service expenses	—	11,978	(11,082)	896
Costs of purchased oil	—	44,020	—	44,020
General and administrative[(1)]	20,121	1,887	—	22,008
Depletion, depreciation and amortization[(2)]	35,683	2,320	—	38,003
Other operating expenses[(3)]	1,382	55	—	1,437
Operating income	$53,109	$1,130	$(2,178)	$52,061
Other financial information:				
Income from equity method investee	$—	$2,471	$—	$2,471
Interest expense[(4)]	$21,752	$1,421	$—	$23,173
Capital expenditures	$123,157	$4,386	$—	$127,543
Gross property and equipment[(5)]	$5,979,858	$412,177	$(13,226)	$6,378,809
Three months ended June 30, 2016:				
Revenues:				
Oil, NGL and natural gas sales	$102,526	$—	$—	$102,526
Midstream service revenues	—	11,138	(9,506)	1,632
Sales of purchased oil	—	42,615	—	42,615
Total revenues	102,526	53,753	(9,506)	146,773
Costs and expenses:				
Lease operating expenses, including production and ad valorem taxes	29,793	—	(2,586)	27,207
Midstream service expenses	—	6,572	(5,394)	1,178
Costs of purchased oil	—	44,012	—	44,012
General and administrative[(1)]	18,818	1,684	—	20,502
Depletion, depreciation and amortization[(2)]	31,969	2,208	—	34,177
Impairment expense	963	—	—	963
Other operating expenses[(3)]	806	54	—	860
Operating income (loss)	$20,177	$(777)	$(1,526)	$17,874
Other financial information:				
Income from equity method investee	$—	$3,696	$—	$3,696
Interest expense[(4)]	$22,050	$1,462	$—	$23,512
Capital expenditures	$92,089	$1,488	$—	$93,577

Gross property and equipment[5]	$5,484,416	$366,858	$ (4,604	)	$ 5,846,670
Six months ended June 30, 2017:					
Revenues:					
Oil, NGL and natural gas sales	$281,496	$1,641	$ (2,564	)	$ 280,573
Midstream service revenues	—	35,738	(30,036	)	5,702
Sales of purchased oil	—	89,732	—		89,732
Total revenues	281,496	127,111	(32,600	)	376,007
Costs and expenses:					
Lease operating expenses, including production and ad valorem taxes	61,563	—	(7,214	)	54,349
Midstream service expenses	—	22,212	(20,400	)	1,812
Costs of purchased oil	—	94,276	—		94,276
General and administrative[1]	43,564	4,041	—		47,605
Depletion, depreciation and amortization[2]	67,480	4,635	—		72,115
Other operating expenses[3]	2,355	108	—		2,463
Operating income	$106,534	$1,839	$ (4,986	)	$ 103,387
Other financial information:					
Income from equity method investee	$—	$5,539	$ —		$ 5,539

TABLE CONTINUES ON NEXT PAGE

(in thousands)	Exploration and production	Midstream and marketing	Eliminations	Consolidated company
Interest expense[4]	$43,066	$2,827	$ —	$45,893
Capital expenditures	$234,902	$6,117	$ —	$241,019
Gross property and equipment[5]	$5,979,858	$412,177	$ (13,226)	$6,378,809
Six months ended June 30, 2016:				
Revenues:				
Oil, NGL and natural gas sales	$175,668	$—	$ —	$175,668
Midstream service revenues	—	22,405	(18,972)	3,433
Sales of purchased oil	—	74,229	—	74,229
Total revenues	175,668	96,634	(18,972)	253,330
Costs and expenses:				
Lease operating expenses, including production and ad valorem taxes	59,157	—	(4,997)	54,160
Midstream service expenses	—	13,081	(11,294)	1,787
Costs of purchased oil	—	76,958	—	76,958
General and administrative[1]	36,497	3,456	—	39,953
Depletion, depreciation and amortization[2]	71,261	4,394	—	75,655
Impairment expense	162,027	—	—	162,027
Other operating expenses[3]	1,598	106	—	1,704
Operating loss	$(154,872)	$(1,361)	$ (2,681)	$(158,914)
Other financial information:				
Income from equity method investee	$—	$5,994	$ —	$5,994
Interest expense[4]	$44,353	$2,864	$ —	$47,217
Capital expenditures	$197,874	$3,425	$ —	$201,299
Gross property and equipment[5]	$5,484,416	$366,858	$ (4,604)	$5,846,670

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(1) General and administrative expenses were allocated to the three months ended June 30, 2017, March 31, 2017, June 30, 2016 and March 31, 2016 based on the number of employees in the respective segment as of the respective three-month period end dates. Certain components of general and administrative expenses, primarily payroll, deferred compensation and vehicle expenses, were not allocated but were actual expenses for each segment. Land and geology expenses were not allocated to the midstream and marketing segment.

(2) Depletion, depreciation and amortization were actual expenses for each segment with the exception of the allocation of depreciation of other fixed assets, which were allocated to the three months ended June 30, 2017, March 31, 2017, June 30, 2016 and March 31, 2016 based on the number of employees in the respective segment as of the respective three-month period end dates. Certain components of depreciation and amortization of other fixed assets, primarily vehicles, were not allocated but were actual expenses for each segment.

(3) Other operating expenses consist of (i) accretion of asset retirement obligations and minimum volume commitments for the three and six months ended June 30, 2017 and (ii) accretion of asset retirement obligations for the three and six months ended June 30, 2016. These were actual expenses and were not allocated.

(4) Interest expense for the three months ended June 30, 2017 and March 31, 2017 was allocated to the exploration and production segment based on gross property and equipment as of June 30, 2017 and March 31, 2017, respectively, and allocated to the midstream and marketing segment based on gross property and equipment and life-to-date contributions to the Company's equity method investee as of June 30, 2017 and March 31, 2017, respectively. Interest expense for the three and six months ended June 30, 2016 was allocated to the exploration and production

segment based on gross property and equipment as of June 30, 2016 and allocated to the midstream and marketing segment based on gross property and equipment and life-to-date contributions to the Company's equity method investee as of June 30, 2016. Certain components of other fixed assets, primarily vehicles, were not allocated but were actual assets for the each segment.

(5) Gross property and equipment for the midstream and marketing segment includes equity method investment of $249.5 million and $213.6 million as of June 30, 2017 and 2016, respectively. Other fixed assets were allocated based on the number of employees in the respective segment as of June 30, 2017 and 2016. Certain components of other fixed assets, primarily vehicles, were not allocated but were actual assets for each segment.

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Note 14—Subsidiary guarantors

The Guarantors have fully and unconditionally guaranteed the January 2022 Notes, the May 2022 Notes, the March 2023 Notes and the Senior Secured Credit Facility, subject to the Releases. In accordance with practices accepted by the SEC, Laredo has prepared condensed consolidating financial statements to quantify the balance sheets, results of operations and cash flows of such subsidiaries as subsidiary guarantors. The following unaudited condensed consolidating balance sheets as of June 30, 2017 and December 31, 2016, unaudited condensed consolidating statements of operations for the three and six months ended June 30, 2017 and 2016 and unaudited condensed consolidating statements of cash flows for the six months ended June 30, 2017 and 2016 present financial information for Laredo on a stand-alone basis (carrying any investment in subsidiaries under the equity method), financial information for the subsidiary guarantors on a stand-alone basis (carrying any investment in subsidiaries under the equity method), and the consolidation and elimination entries necessary to arrive at the information for the Company on a condensed consolidated basis. Deferred income taxes for LMS and for GCM are recorded on Laredo's balance sheets, statements of operations and statements of cash flows as they are disregarded entities for income tax purposes. Laredo and the Guarantors are not restricted from making intercompany distributions to each other. During the six months ended June 30, 2016, certain assets were transferred from LMS to Laredo at historical cost.

Condensed consolidating balance sheet
June 30, 2017
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Accounts receivable, net	$60,506	$ 11,601	$ —	$ 72,107
Other current assets	92,062	3,495	—	95,557
Oil and natural gas properties, net	1,332,884	9,272	(13,226)	1,328,930
Midstream service assets, net	—	128,941	—	128,941
Other fixed assets, net	40,966	449	—	41,415
Investment in subsidiaries and equity method investment	384,303	249,492	(384,303)	249,492
Other long-term assets	21,104	3,708	—	24,812
Total assets	$1,931,825	$ 406,958	$ (397,529)	$ 1,941,254
Accounts payable	$8,984	$ 1,793	$ —	$ 10,777
Other current liabilities	143,673	17,633	—	161,306
Long-term debt, net	1,390,277	—	—	1,390,277
Other long-term liabilities	51,262	3,229	—	54,491
Stockholders' equity	337,629	384,303	(397,529)	324,403
Total liabilities and stockholders' equity	$1,931,825	$ 406,958	$ (397,529)	$ 1,941,254

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Condensed consolidating balance sheet
December 31, 2016
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Accounts receivable, net	$70,570	$16,297	$—	$86,867
Other current assets	65,884	2,026	—	67,910
Oil and natural gas properties, net	1,194,801	9,293	(8,240)	1,195,854
Midstream service assets, net	—	126,240	—	126,240
Other fixed assets, net	44,221	552	—	44,773
Investment in subsidiaries and equity method investment	376,028	243,953	(376,028)	243,953
Other long-term assets	13,065	3,684	—	16,749
Total assets	$1,764,569	$402,045	$(384,268)	$1,782,346
Accounts payable	$14,427	$627	$—	$15,054
Other current liabilities	150,531	22,360	—	172,891
Long-term debt, net	1,353,909	—	—	1,353,909
Other long-term liabilities	56,889	3,030	—	59,919
Stockholders' equity	188,813	376,028	(384,268)	180,573
Total liabilities and stockholders' equity	$1,764,569	$402,045	$(384,268)	$1,782,346

Condensed consolidating statement of operations
For the three months ended June 30, 2017
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Total revenues	$142,224	$61,454	$(16,677)	$187,001
Total costs and expenses	91,140	58,299	(14,499)	134,940
Operating income	51,084	3,155	(2,178)	52,061
Interest expense	(23,173)	—	—	(23,173)
Other non-operating income	35,377	2,414	(5,569)	32,222
Income before income tax	63,288	5,569	(7,747)	61,110
Income tax	—	—	—	—
Net income	$63,288	$5,569	$(7,747)	$61,110

Condensed consolidating statement of operations
For the six months ended June 30, 2017
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Total revenues	$281,367	$127,240	$(32,600)	$376,007
Total costs and expenses	179,169	121,065	(27,614)	272,620
Operating income	102,198	6,175	(4,986)	103,387
Interest expense	(45,893)	—	—	(45,893)
Other non-operating income	78,067	5,332	(11,507)	71,892
Income before income tax	134,372	11,507	(16,493)	129,386
Income tax	—	—	—	—
Net income	$134,372	$11,507	$(16,493)	$129,386

Condensed consolidating statement of operations

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For the three months ended June 30, 2016
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Total revenues	$ 102,511	$ 53,768	$ (9,506)	$ 146,773
Total costs and expenses	84,137	52,742	(7,980)	128,899
Operating income	18,374	1,026	(1,526)	17,874
Interest expense	(23,512)	—	—	(23,512)
Other non-operating income (expense)	(64,768)	3,692	(4,718)	(65,794)
Income (loss) before income tax	(69,906)	4,718	(6,244)	(71,432)
Income tax	—	—	—	—
Net income (loss)	$ (69,906)	$ 4,718	$ (6,244)	$ (71,432)

Condensed consolidating statement of operations
For the six months ended June 30, 2016
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Total revenues	$ 175,633	$ 96,669	$ (18,972)	$ 253,330
Total costs and expenses	334,201	94,334	(16,291)	412,244
Operating income (loss)	(158,568)	2,335	(2,681)	(158,914)
Interest expense	(47,217)	—	—	(47,217)
Other non-operating income (expense)	(43,337)	5,983	(8,318)	(45,672)
Income (loss) before income tax	(249,122)	8,318	(10,999)	(251,803)
Income tax	—	—	—	—
Net income (loss)	$ (249,122)	$ 8,318	$ (10,999)	$ (251,803)

Condensed consolidating statement of cash flows
For the six months ended June 30, 2017
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Net cash provided by operating activities	$ 159,048	$ 9,360	$ (11,507)	$ 156,901
Change in investment between affiliates	(8,264)	(3,243)	11,507	—
Capital expenditures and other	(171,461)	(6,117)	—	(177,578)
Net cash provided by financing activities	23,029	—	—	23,029
Net increase in cash and cash equivalents	2,352	—	—	2,352
Cash and cash equivalents, beginning of period	32,671	1	—	32,672
Cash and cash equivalents, end of period	$ 35,023	$ 1	$ —	$ 35,024

Condensed consolidating statement of cash flows
For the six months ended June 30, 2016
(Unaudited)

(in thousands)	Laredo	Subsidiary Guarantors	Intercompany eliminations	Consolidated company
Net cash provided by operating activities	$139,610	$ 7,339	$ (8,318)	$ 138,631
Change in investment between affiliates	(47,069)	38,751	8,318	—
Capital expenditures and other	(197,540)	(46,090)	—	(243,630)
Net cash provided by financing activities	93,154	—	—	93,154
Net decrease in cash and cash equivalents	(11,845)	—	—	(11,845)
Cash and cash equivalents, beginning of period	31,153	1	—	31,154
Cash and cash equivalents, end of period	$19,308	$ 1	$ —	$ 19,309

Note 15—Recently issued or adopted accounting pronouncements

The Company considers the applicability and impact of all accounting standard updates ("ASU") issued by the Financial Accounting Standards Board ("FASB"). The ASUs listed below were either adopted during the six months ended June 30, 2017 or the discussion of the ASU was determined to be meaningful to the Company's consolidated financial statements.

In May 2014, the FASB issued a comprehensive new revenue recognition standard that supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and industry-specific guidance in Subtopic 932-605, Extractive Activities—Oil and Gas—Revenue Recognition. The core principle of the new guidance is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for transferring those goods or services. The new standard also requires significantly expanded disclosure regarding the qualitative and quantitative information of an entity's nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The standard creates a five-step model that requires companies to exercise judgment when considering the terms of a contract and all relevant facts and circumstances. The standard allows for several transition methods: (a) a full retrospective adoption in which the standard is applied to all of the periods presented, or (b) a modified retrospective adoption in which the standard is applied only to the most current period presented in the financial statements, including additional disclosures of the standard's application impact to individual financial statement line items. In March, April, May and December 2016, the FASB issued new guidance in Topic 606, Revenue from Contracts with Customers, to address the following potential implementation issues of the new revenue standard: (a) to clarify the implementation guidance on principal versus agent considerations, (b) to clarify the identification of performance obligations and the licensing implementation guidance and (c) to address certain issues in the guidance on assessing collectability, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition. This standard is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The Company follows the sales method of accounting for oil, NGL and natural gas production, which is generally consistent with the revenue recognition provision of the new standard. However, the Company is still evaluating the impact this standard will have on its consolidated financial statements upon adoption. The evaluation process includes (i) review of revenue contracts and transactions in both of the exploration and production and midstream and marketing segments and (ii) assessing the impact this guidance will have on our processes and internal controls. The Company expects to apply the modified retrospective method upon adoption of this standard on the effective date of January 1, 2018.

In February 2016, the FASB issued new guidance in Topic 842, Leases. The core principle of the new guidance is that a lessee should recognize the assets and liabilities that arise from leases in the statement of financial position. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and

liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. Reasonably certain is a high threshold that is consistent with and intended to be applied in the same way as the reasonably assured threshold in the previous lease guidance. In addition, also consistent with the previous lease guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease

liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from previous GAAP. There continues to be a differentiation between finance leases and operating leases. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in this ASU is permitted. The Company is in the process of evaluating the potential impact of adopting this guidance, and the primary effect will be to record assets and obligations for contracts currently recognized as operating leases with a term greater than 12 months and evaluate operating leases with a term less than or equal to 12 months for election. The Company does not intend to adopt the standard early.

In January 2017, the FASB issued new guidance in Topic 805, Business Combinations, to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes. The amendments in this ASU provide a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. If the screen is not met, the amendments in this ASU (i) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create an output and (ii) remove the evaluation of whether a market participant could replace missing elements. The amendments provide a framework to assist entities in evaluating whether both an input and a substantive process are present. The framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, outputs generally are a key element of a business; therefore, the FASB has developed more stringent criteria for sets without outputs. Lastly, the amendments in this ASU narrow the definition of the term output so that the term is consistent with how outputs are described in Topic 606. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those periods. The amendments in this ASU should be applied prospectively on or after the effective date. Early application of the amendments in this ASU is permitted. The Company is currently evaluating the impact this standard will have on its consolidated financial statements upon adoption.

Note 16—Subsequent events

a. Senior Secured Credit Facility

On July 12, 2017, the Company borrowed $10.0 million on the Senior Secured Credit Facility. The outstanding balance under the Senior Secured Credit Facility was $115.0 million as of August 7, 2017.

b. Medallion capital call

Subsequent to June 30, 2017, the Company approved $24.6 million to fund continued expansion activities on existing portions of Medallion's pipeline infrastructure in order to gather additional third-party production. See Note 2.h for additional discussion regarding Medallion and see Note 12.a for discussion of items included in the Company's unaudited consolidated financial statements related to Medallion.

Note 17—Supplementary information

Costs incurred in oil and natural gas property acquisition, exploration and development activities

Costs incurred in the acquisition, exploration and development of oil, NGL and natural gas assets are presented below:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Property acquisition costs:				—
Evaluated	$—	$—	$—	$—
Unevaluated	—	—	—	—
Exploration costs	5,658	19,769	21,201	27,032
Development costs[1]	125,738	70,806	236,896	152,692
Total costs incurred	$131,396	$90,575	$258,097	$179,724

(1) Development costs include $0.1 million in asset retirement obligations for each of the three months ended June 30, 2017 and 2016, and $0.2 million for each of the six months ended June 30, 2017 and 2016.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited consolidated financial statements and condensed notes thereto included elsewhere in this Quarterly Report as well as our audited consolidated financial statements and notes thereto included in our 2016 Annual Report. The following discussion contains "forward-looking statements" that reflect our future plans, estimates, beliefs and expected performance. We caution that assumptions, expectations, projections, intentions or beliefs about future events may, and often do, vary from actual results and the differences can be material. Please see "Cautionary Statement Regarding Forward-Looking Statements." Except for purposes of the unaudited consolidated financial statements and condensed notes thereto included elsewhere in this Quarterly Report, references in this Quarterly Report to "Laredo," "we," "us," "our" or similar terms refer to Laredo, LMS and GCM collectively unless the context otherwise indicates or requires. All amounts, dollars and percentages presented in this Quarterly Report are rounded and therefore approximate.

Executive overview

We are an independent energy company focused on the acquisition, exploration and development of oil and natural gas properties, and the gathering of oil and liquids-rich natural gas from such properties, primarily in the Permian Basin in West Texas. Since our inception, we have grown primarily through our drilling program coupled with select strategic acquisitions and joint ventures.

Our financial and operating performance for the three months ended June 30, 2017 included the following:

- Oil, NGL and natural gas sales of $141.8 million, compared to $102.5 million for the three months ended June 30, 2016;
- Average daily sales volumes of 58,632 BOE/D, compared to 47,667 BOE/D for the three months ended June 30, 2016;
- Net income of $61.1 million, compared to a net loss of $71.4 million, for the three months ended June 30, 2016; and
- Adjusted EBITDA (a non-GAAP financial measure) of $114.3 million, compared to $110.0 million for the three months ended June 30, 2016. See page 49 for a discussion and reconciliation of Adjusted EBITDA.

Our financial and operating performance for the six months ended June 30, 2017 included the following:

- Oil, NGL and natural gas sales of $280.6 million, compared to $175.7 million for the six months ended June 30, 2016;
- Average daily sales volumes of 55,536 BOE/D, compared to 46,935 BOE/D for the six months ended June 30, 2016;
- Net income of $129.4 million, compared to a net loss of $251.8 million, including a non-cash full cost ceiling impairment of $161.1 million, for the six months ended June 30, 2016; and
- Adjusted EBITDA (a non-GAAP financial measure) of $221.7 million, compared to $208.3 million for the six months ended June 30, 2016. See page 49 for a discussion and reconciliation of Adjusted EBITDA.

Pricing and reserves

Our results of operations are heavily influenced by oil, NGL and natural gas prices. Oil, NGL and natural gas price fluctuations are caused by changes in global and regional supply and demand, market uncertainty, economic conditions and a variety of additional factors. Historically, commodity prices have experienced significant fluctuations, and additional changes in commodity prices may affect the economic viability of, and our ability to fund, our drilling projects, as well as the economic valuation and economic recovery of oil, NGL and natural gas reserves. For the three months ended June 30, 2017 and 2016, the Realized Prices utilized to value our reserves were $43.64 per Bbl for oil, $15.16 per Bbl for NGL and $2.15 per Mcf for natural gas, and $37.96 per Bbl for oil, $10.80 per Bbl for NGL and $1.64 per Mcf for natural gas, respectively. The Realized Prices used to estimate proved reserves for all periods do not include derivative transactions. The unamortized cost of our evaluated oil and natural gas properties did not exceed the full cost ceiling amount as of June 30, 2017, March 31, 2017 or June 30, 2016 and as such, we did not record a 2017 second-quarter, 2017 first-quarter or 2016 second-quarter, respectively, full cost ceiling impairment. See Note 2.g to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for a discussion regarding prices used to value our reserves and our 2016 first-quarter full cost ceiling impairment.

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We have entered into a number of derivative contracts that have enabled us to offset a portion of the changes in our cash flow caused by price fluctuations for our sales of oil, NGL and natural gas as discussed in "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

Core areas of operations

The oil and liquids-rich Permian Basin is characterized by multiple target horizons, extensive production histories, long-lived reserves, high drilling success rates and high initial production rates. As of June 30, 2017, we had assembled 125,967 net acres in the Permian Basin.

Sources of our revenue

Our revenues are derived from the sale of produced oil, NGL and natural gas within the continental United States, the sale of purchased oil and providing midstream services to third parties. Our revenues do not include the effects of derivatives. For the three months ended June 30, 2017, our revenues were comprised of 56% sales of produced oil, 11% sales of produced NGL, 9% sales of produced natural gas, 23% sales of purchased oil and 1% midstream services. For the six months ended June 30, 2017, our revenues were comprised of 54% sales of produced oil, 11% sales of produced NGL, 10% sales of produced natural gas, 24% sales of purchased oil and 1% midstream services. Our oil, NGL and natural gas revenues may vary significantly from period to period as a result of changes in volumes of production and/or changes in commodity prices. Our sales of purchased oil revenue may vary due to changes in oil prices and market differentials. Our midstream service revenues may vary due to oil throughput fees and the level of services provided to third parties for (i) gathered natural gas, (ii) gas lift fees and (iii) water services.

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Results of operations consolidated

For the three and six months ended June 30, 2017 as compared to the three and six months ended June 30, 2016

Oil, NGL and natural gas sales volumes, revenues and pricing

The following table sets forth information regarding oil, NGL and natural gas sales volumes, revenues and average sales prices per BOE sold, for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Sales volumes:				
Oil (MBbl)	2,482	2,012	4,602	4,018
NGL (MBbl)	1,433	1,153	2,696	2,219
Natural gas (MMcf)	8,524	7,038	16,524	13,834
Oil equivalents (MBOE)[(1)(2)]	5,336	4,338	10,052	8,542
Average daily sales volumes (BOE/D)[(2)]	58,632	47,667	55,536	46,935
% Oil	47 %	46 %	46 %	47 %
Oil, NGL and natural gas sales (in thousands):				
Oil	$104,214	$79,201	$203,681	$134,395
NGL	19,801	14,120	40,629	23,172
Natural gas	17,822	9,205	36,263	18,101
Total oil, NGL and natural gas sales	$141,837	$102,526	$280,573	$175,668
Average sales prices[(2)]:				
Oil, realized ($/Bbl)[(3)]	$42.00	$39.37	$44.26	$33.45
NGL, realized ($/Bbl)[(3)]	$13.82	$12.24	$15.07	$10.44
Natural gas, realized ($/Mcf)[(3)]	$2.09	$1.31	$2.19	$1.31
Average price, realized ($/BOE)[(3)]	$26.58	$23.64	$27.91	$20.56
Oil, hedged ($/Bbl)[(4)]	$46.95	$58.86	$48.22	$57.85
NGL, hedged ($/Bbl)[(4)]	$13.61	$12.24	$14.75	$10.44
Natural gas, hedged ($/Mcf)[(4)]	$2.12	$2.13	$2.21	$2.10
Average price, hedged ($/BOE)[(4)]	$28.88	$34.00	$29.66	$33.33

(1) BOE is calculated using a conversion rate of six Mcf per one Bbl.

(2) The volumes presented are based on actual results and are not calculated using the rounded numbers presented in the table above.

(3) Realized oil, NGL and natural gas prices are the actual prices realized at the wellhead adjusted for quality, transportation fees, geographical differentials, marketing bonuses or deductions and other factors affecting the price received at the wellhead. The prices presented are based on actual results and are not calculated using the rounded numbers presented in the table above.

(4) Hedged prices reflect the after-effect of our hedging transactions on our average sales prices. Our calculation of such after-effects includes current period settlements of matured derivatives in accordance with GAAP and an adjustment to reflect premiums incurred previously or upon settlement that are attributable to instruments that settled in the period. The prices presented are based on actual results and are not calculated using the rounded numbers presented in the table above.

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The following table presents cash settlements received (paid) for matured derivatives and premiums incurred previously or upon settlement attributable to instruments that settled during the periods utilized in our calculation of the hedged prices presented above:

(in thousands)	Three months ended June 30, 2017	2016	Six months ended June 30, 2017	2016
Cash settlements received (paid) for matured derivatives:				
Oil	$12,969	$41,616	$20,217	$102,308
NGL	(296)	—	(864)	—
Natural gas	1,032	5,766	1,803	11,011
Total	$13,705	$47,382	$21,156	$113,319
Premiums paid attributable to contracts that matured during the respective period:				
Oil	$(679)	$(2,413)	$(2,021)	$(4,263)
Natural gas	(767)	—	(1,532)	—
Total	$(1,446)	$(2,413)	$(3,553)	$(4,263)

Changes in average realized sales prices and sales volumes caused the following changes to our oil, NGL and natural gas revenues between the three months ended June 30, 2017 and 2016:

(in thousands)	Oil	NGL	Natural gas	Total net effect of change
2016 Revenues	$79,201	$14,120	$ 9,205	$102,526
Effect of changes in average realized sales prices	6,508	2,253	6,672	15,433
Effect of changes in sales volumes	18,505	3,428	1,945	23,878
2017 Revenues	$104,214	$19,801	$ 17,822	$141,837

Changes in average realized sales prices and sales volumes caused the following changes to our oil, NGL and natural gas revenues between the six months ended June 30, 2017 and 2016:

(in thousands)	Oil	NGL	Natural gas	Total net effect of change
2016 Revenues	$134,395	$23,172	$ 18,101	$175,668
Effect of changes in average realized sales prices	49,747	12,472	14,642	76,861
Effect of changes in sales volumes	19,539	4,985	3,520	28,044
2017 Revenues	$203,681	$40,629	$ 36,263	$280,573

Oil revenue. Our oil revenue is a function of oil production volumes sold and average sales prices received for those volumes. The increase in oil revenue of $25.0 million, or 32%, for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016 is due to a 23% increase in oil sales volumes and a 7% increase in average oil prices realized.

The increase in oil revenue of $69.3 million, or 52%, for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016 is due to a 32% increase in average oil prices realized and a 15% increase in oil sales volumes.

NGL revenue. Our NGL revenue is a function of NGL production volumes sold and average sales prices received for those volumes. The increase in NGL revenue of $5.7 million, or 40%, for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016 is due to a 24% increase in NGL sales volumes and a 13% increase in average NGL prices realized.

The increase in NGL revenue of $17.5 million, or 75%, for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016 is due to a 44% increase in average NGL prices realized and a 21% increase in NGL sales volumes.

Natural gas revenue. Our natural gas revenue is a function of natural gas production volumes sold and average sales prices received for those volumes. The increase in natural gas revenue of $8.6 million, or 94%, for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016 is due to a 60% increase in average natural gas prices realized and an 21% increase in natural gas sales volumes.

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The increase in natural gas revenue of $18.2 million, or 100%, for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016 is due to a 67% increase in average natural gas prices realized and an 19% increase in natural gas sales volumes.

Costs and expenses

The following table sets forth information regarding costs and expenses and average costs per BOE sold for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands except for per BOE sold data)	2017	2016	2017	2016
Costs and expenses:				
Lease operating expenses	$20,104	$19,225	$37,096	$39,743
Production and ad valorem taxes	8,472	7,982	17,253	14,417
Midstream service expenses	896	1,178	1,812	1,787
Costs of purchased oil	44,020	44,012	94,276	76,958
General and administrative:				
Cash	13,321	14,429	29,694	30,042
Non-cash stock-based compensation, net of amounts capitalized	8,687	6,073	17,911	9,911
Depletion, depreciation and amortization	38,003	34,177	72,115	75,655
Impairment expense	—	963	—	162,027
Other operating expenses	1,437	860	2,463	1,704
Total	$134,940	$128,899	$272,620	$412,244
Average costs per BOE sold[(1)]:				
Lease operating expenses	$3.77	$4.43	$3.69	$4.65
Production and ad valorem taxes	1.59	1.84	1.72	1.69
Midstream service expenses	0.17	0.27	0.18	0.21
General and administrative:				
Cash	2.50	3.33	2.95	3.52
Non-cash stock-based compensation, net of amounts capitalized	1.63	1.40	1.78	1.16
Depletion, depreciation and amortization	7.12	7.88	7.17	8.86
Total	$16.78	$19.15	$17.49	$20.09

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(1) Average costs per BOE sold are based on actual amounts and are not calculated using the rounded numbers presented in the table above.

Lease operating expenses. Lease operating expenses, which include workover expenses, increased by $0.9 million, or 5%, and decreased by $2.6 million, or 7%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. On a per BOE sold basis, lease operating expenses decreased 15% and 21% for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016 mainly due to previous investments in field infrastructure. We continue to focus on economic efficiencies associated with the usage and procurement of products and services related to lease operating expenses.

Production and ad valorem taxes. Production and ad valorem taxes increased by $0.5 million, or 6%, and $2.8 million, or 20%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. The quarter-over-quarter increase is due to a $1.7 million increase in production taxes partially offset by a $1.2 million decrease in ad valorem taxes. The year-to-date increase over the comparable period in 2016 is due to a $5.2 million increase in production taxes partially offset by a $2.4 million decrease in ad valorem taxes. Production taxes are based on and fluctuate in proportion to our oil, NGL and natural gas revenue. Ad valorem taxes are based on and fluctuate in proportion to the taxable value assessed by the various counties where our oil and natural gas properties are located.

Midstream service expenses. See "—Results of operations - midstream and marketing" for a discussion of these expenses.

Costs of purchased oil. See "—Results of operations - midstream and marketing" for a discussion of these expenses.

General and administrative ("G&A"). G&A increased by $1.5 million, or 7%, and $7.7 million, or 19%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. The most significant change in our G&A was stock-based compensation, net of amounts capitalized, which increased by $2.6 million, or 43%, and $8.0 million, or 81%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. These increases are mainly due to the timing of our annual issuance of restricted stock awards, stock option awards and performance share awards under our LTIP, which occurred during the first quarter of 2017 and during the second quarter of 2016. The quarter-over-quarter increase in G&A was partially offset by a decrease in salaries, benefits and bonuses, net of amounts capitalized of $0.7 million.

The fair values for each of our restricted stock awards issued were calculated based on the value of our stock price on the grant date in accordance with GAAP and are being expensed on a straight-line basis over their associated requisite service periods. The fair values for each of our restricted stock option awards were determined using a Black-Scholes valuation model in accordance with GAAP and are being expensed on a straight-line basis over their associated four-year requisite service periods.

Our performance share awards are accounted for as equity awards and are included in stock-based compensation expense. The fair values for each of our performance share awards issued were based on a projection of the performance of our stock price relative to a peer group, defined in each performance share awards' agreement, utilizing a forward-looking Monte Carlo simulation. The fair values for each of our performance share awards will not be re-measured after their initial grant-date valuation and are being expensed on a straight-line basis over their associated three-year requisite service periods.

See Notes 2.n and 5 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional information regarding our stock and performance-based compensation.

Depletion, depreciation and amortization ("DD&A"). The following table sets forth the components of our DD&A for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands except for per BOE sold data)	2017	2016	2017	2016
Depletion of evaluated oil and natural gas properties	$34,338	$30,630	$64,752	$68,457
Depreciation of midstream service assets	2,177	2,097	4,328	4,168
Depreciation and amortization of other fixed assets	1,488	1,450	3,035	3,030
Total DD&A	$38,003	$34,177	$72,115	$75,655
DD&A per BOE sold	$7.12	$7.88	$7.17	$8.86

DD&A increased by $3.8 million, or 11%, and decreased by $3.5 million, or 5%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. On a per BOE sold basis, DD&A decreased for each of the three and six months ended June 30, 2017 compared to the same periods in 2016, mainly due to positive well results.

Impairment expense. Our net book value of evaluated oil and natural gas properties exceeded the full cost ceiling amount as of March 31, 2016, and as a result, we recorded a non-cash full cost ceiling impairment of $161.1 million. There were no comparable full cost ceiling impairments recorded during the three and six months ended June 30, 2017 or the three months ended June 30, 2016. For further discussion of our non-cash full cost ceiling impairment accounting policy, see Note 2.g to our unaudited consolidated financial statements included elsewhere in this Quarterly Report. There were no long-lived assets impairments recorded during the six months ended June 30, 2017 and 2016. Inventory impairments of $1.0 million were recorded for each of the three and six months ended June 30, 2016. There were no inventory impairments recorded during the six months ended June 30, 2017. For further discussion of long-lived assets and inventory impairment accounting policies, see Note 2.i to our unaudited consolidated financial statements included elsewhere in this Quarterly Report.

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Non-operating income (expense)

The following table sets forth the components of non-operating income (expense) for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Non-operating income (expense):				
Gain (loss) on derivatives, net	$28,897	$(68,518)	$65,568	$(50,633)
Income from equity method investee	2,471	3,696	5,539	5,994
Interest expense	(23,173)	(23,512)	(45,893)	(47,217)
Interest and other income	49	11	194	110
Write-off of debt issuance costs	—	(842)	—	(842)
Gain (loss) on disposal of assets, net	805	(141)	591	(301)
Non-operating income (expense), net	$9,049	$(89,306)	$25,999	$(92,889)

Gain (loss) on derivatives, net. The following table presents the changes in the components of gain (loss) on derivatives, net for the periods presented:

(in thousands)	Three months ended June 30, 2017 compared to 2016	Six months ended June 30, 2017 compared to 2016
Changes in gain (loss) on derivatives, net:		
Fair value of derivatives outstanding	$126,858	$284,130
Cash settlements received for matured derivatives, net	(33,677)	(92,163)
Cash settlements received for early terminations of derivatives, net	4,234	(75,766)
Total changes in gain (loss) on derivatives, net	$97,415	$116,201

The changes in fair value of derivatives outstanding are the result of new and expiring contracts and the changing relationship between our outstanding contract prices and the future market prices in the forward curves, which we use to calculate the fair value of our derivatives. In general, if no contracts were entered into, terminated or modified, we experience gains during periods of decreasing market prices and losses during periods of increasing market prices. Net cash settlements received for matured derivatives are based on the cash settlement prices of our matured derivatives compared to the prices specified in the derivative contracts.

During the three and six months ended June 30, 2017, we received proceeds from a hedge restructuring in which we early terminated a derivative contract swap, resulting in a termination amount due to us of $4.2 million. The $4.2 million was settled in full by applying the proceeds to pay the premium on one new derivative contract collar entered into during the restructuring.

During the six months ended June 30, 2016, we received proceeds from a hedge restructuring in which we early terminated floors of certain derivative contract collars, resulting in a termination amount due to us of $80.0 million. The $80.0 million was settled in full by applying the proceeds to the premiums on two new derivative contracts entered into as part of the hedge restructuring.

See Notes 2.e, 7 and 8.a to our unaudited consolidated financial statements included elsewhere in this Quarterly Report and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" for additional information regarding our derivatives.

Income from equity method investee. See "—Results of operations - midstream and marketing" for a discussion of this income.

Interest expense. Interest expense decreased by $0.3 million and $1.3 million for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. These decreases are primarily due to a lower outstanding balance on our Senior Secured Credit Facility.

Gain (loss) on disposal of assets, net. Gain (loss) on disposal of assets, net increased by $0.9 million for each of the three and six months ended June 30, 2017 compared to the same periods in 2016. From time to time, we dispose of materials and supplies inventory and other fixed assets. The associated gain or loss recorded during the period fluctuates depending upon the volume of the assets disposed, their associated net book value and, in the case of a disposal by sale, the sale price.

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Income tax. Since September 30, 2015, we have recorded a full valuation allowance against our net deferred tax position. As such, our effective tax rate was 0% during the three and six months ended June 30, 2017 and 2016. For further discussion of our income tax position, see Note 6 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report.

Results of operations - midstream and marketing

The following table presents selected financial information regarding our midstream and marketing operating segment for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Revenues:				
Natural gas sales	$825	$—	$1,641	$—
Midstream service revenues	18,104	11,138	35,738	22,405
Sales of purchased oil	42,461	42,615	89,732	74,229
Total revenues	61,390	53,753	127,111	96,634
Costs and expenses:				
Midstream service expenses	11,978	6,572	22,212	13,081
Costs of purchased oil	44,020	44,012	94,276	76,958
General and administrative[(1)]	1,887	1,684	4,041	3,456
Depreciation and amortization[(2)]	2,320	2,208	4,635	4,394
Accretion of asset retirement obligations[(3)]	55	54	108	106
Operating income (loss)	$1,130	$(777)	$1,839	$(1,361)
Other financial information:				
Income from equity method investee	$2,471	$3,696	$5,539	$5,994
Interest expense[(4)]	$1,421	$1,462	$2,827	$2,864

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(1) G&A expenses were allocated to the three months ended June 30, 2017 and 2016 based on the number of employees in the midstream and marketing segment as of June 30, 2017 and 2016, respectively, and were allocated to the three months ended March 31, 2017 and 2016 based on the number of employees in the midstream and marketing segment as of March 31, 2017 and 2016, respectively. Certain components of G&A expenses, primarily payroll, deferred compensation and vehicle expenses, were not allocated but were actual expenses for the segment. Land and geology expenses were not allocated to the segment.

(2) Depreciation and amortization were actual expenses for the midstream and marketing segment with the exception of the allocation of depreciation of other fixed assets, which were allocated to the three months ended June 30, 2017 and 2016 based on the number of employees in the midstream and marketing segment as of June 30, 2017 and 2016, respectively, and were allocated to the three months ended March 31, 2017 and 2016 based on the number of employees in the midstream and marketing segment as of March 31, 2017 and 2016, respectively. Certain components of depreciation and amortization of other fixed assets, primarily vehicles, were not allocated but were actual expenses for the segment.

(3) Accretion of asset retirement obligations were actual expenses and were not allocated.

(4) Interest expense for the three months ended June 30, 2017 and March 31, 2017 was allocated to the midstream and marketing segment based on gross property and equipment and life-to-date contributions to the Company's equity method investee as of June 30, 2017 and March 31, 2017, respectively. Interest expense for the three and six months ended June 30, 2016 was allocated to the midstream and marketing segment based on gross property and equipment and life-to-date contributions to the Company's equity method investee as of June 30, 2016. Certain components of other fixed assets, primarily vehicles, were not allocated but were actual assets for the segment.

Natural gas sales. These revenues are related to our midstream and marketing segment providing our exploration and production segment with processed natural gas for use in the field. The corresponding cost component of these transactions are included in "Midstream service expenses." See Note 13 to our unaudited consolidated financial

statements included elsewhere in this Quarterly Report for additional information on our operating segments.

Midstream service revenues. Our midstream service revenues increased by $7.0 million and $13.3 million, or 63% and 60%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. These increases are mainly due to increased volume of water services provided.
Sales of purchased oil. Sales of purchased oil increased by $15.5 million, or 21%, for the six months ended June 30, 2017 compared to the same period in 2016 due to the increases in oil prices. For these sales of purchased oil, we purchase oil from third parties in West Texas, transport it on the Bridgetex Pipeline and sell it to a third party in the Houston market. The net loss for the six months ended June 30, 2017 compared to the same period in 2016 on this transaction has increased by $1.8 million, or 67%, mainly due to the relative strengthening of the Midland market.
Midstream service expenses. Midstream service expenses increased by $5.4 million and $9.1 million, or 82% and 70%, for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. Midstream service expenses primarily represent costs incurred to operate and maintain our (i) oil and natural gas gathering and transportation systems and related facilities, (ii) centralized oil storage tanks, (iii) natural gas lift, rig fuel and centralized compression infrastructure and (iv) water storage, recycling and transportation facilities. These increases are due to the continued expansion of the midstream service component of our business.
Costs of purchased oil. Costs of purchased oil increased by $17.3 million, or 23%, for the six months ended June 30, 2017 compared to the same period in 2016 primarily due to the increases in oil prices. These costs include purchasing oil from third parties and transporting it on the Bridgetex Pipeline.
Income from equity method investee. We own 49% of the ownership units of Medallion. The third-party 51% interest-holder has initiated a process to potentially sell 100% of the ownership interests in Medallion within the next 12 months. We account for this investment under the equity method of accounting with our proportionate share of net income reflected in the unaudited consolidated statements of operations as "Income from equity method investee" and the carrying amount reflected in the unaudited consolidated balance sheets as "Investment in equity method investee." Income from equity method investee decreased by $1.2 million and $0.5 million, or 33% and 8% for the three and six months ended June 30, 2017, respectively, compared to the same periods in 2016. The decreases are mainly due to increases in Medallion's depreciation, operating expenses and G&A expenses, partially offset by an increase in Medallion's transportation fee revenue resulting from higher throughput volumes. During the six months ended June 30, 2017, Medallion continued expansion activities on existing portions of its pipeline infrastructure in order to gather additional third-party oil production. The Medallion pipeline system transported an average of 169,105 barrels of oil per day ("BOPD") and 99,039 BOPD for the three months ended June 30, 2017 and 2016, respectively, and an average of 159,026 BOPD and 90,573 BOPD for the six months ended June 30, 2017 and 2016, respectively. See Note 2.h to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional information regarding this investment.
Liquidity and capital resources
Our primary sources of liquidity have been cash flows from operations, proceeds from equity offerings, proceeds from senior unsecured note offerings, borrowings under our Senior Secured Credit Facility and proceeds from asset dispositions. We believe cash flows from operations (including our hedging program) and availability under our Senior Secured Credit Facility provide sufficient liquidity to manage our cash needs and contractual obligations and to fund expected capital expenditures. Our primary operational uses of capital have been for the acquisition, exploration and development of oil and natural gas properties, LMS' infrastructure development and investments in Medallion.
A significant portion of our capital expenditures can be adjusted and managed by us. We continually monitor the capital markets and our capital structure and consider which financing alternatives, including equity and debt capital resources, joint ventures and asset sales, are available to meet our future planned or accelerated capital expenditures. We may make changes to our capital structure from time to time, with the goal of maintaining financial flexibility, preserving or improving liquidity and/or achieving cost efficiency. Such financing alternatives, including capital market transactions and debt repurchases, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material. See Notes 3 and 4 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional discussion of our divestiture of oil and natural gas properties and debt, respectively.

The third-party 51% interest-holder has initiated a process to potentially sell 100% of the ownership interests in Medallion within the next 12 months. There can be no assurance that such potential sale will ultimately be consummated or, if consummated, the specific terms of such sale.

We continually seek to maintain a financial profile that provides operational flexibility. As of August 7, 2017, we had $885.0 million available for borrowings under our Senior Secured Credit Facility. We believe that our operating cash flow and the aforementioned liquidity sources provide us with the financial resources to implement our planned exploration and development activities. We use derivatives to reduce exposure to fluctuations in the prices of oil, NGL and natural gas.

See Note 7.a to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for information regarding our derivative settlement indices and our open hedge positions as of June 30, 2017. As of August 7, 2017, we have not entered into additional hedges subsequent to June 30, 2017.

By removing a significant portion of the price volatility associated with future production, we expect to mitigate, but not eliminate, the potential effects of variability in cash flows from operations due to fluctuations in commodity prices. Our derivative positions will help us stabilize a portion of our expected cash flows from operations in the event of future declines in the price of oil, NGL and natural gas. See "Item 3. Quantitative and Qualitative Disclosures About Market Risk" below.

In January 2017, we completed the sale of 2,900 net acres and working interests in 16 producing vertical wells in the Midland Basin to a third-party buyer for a purchase price of $59.7 million. After transaction costs reflecting an economic effective date of October 1, 2016, the proceeds were $59.5 million, net of working capital and post-closing adjustments. We completed the closing adjustments for this divestiture in May 2017. A portion of these proceeds were used to pay down borrowings on our Senior Secured Credit Facility. The purchase price was recorded as an adjustment to oil and natural gas properties pursuant to the rules governing full cost accounting.

Cash flows

Our cash flows for the periods presented are summarized in the table below:

	Six months ended June 30,	
(in thousands)	2017	2016
Net cash provided by operating activities	$156,901	$138,631
Net cash used in investing activities	(177,578)	(243,630)
Net cash provided by financing activities	23,029	93,154
Net increase (decrease) in cash and cash equivalents	$2,352	$(11,845)

Cash flows from operating activities

Net cash provided by operating activities increased $18.3 million during the six months ended June 30, 2017 compared to the same period in 2016 mainly due to the price-related increase in oil, NGL and natural gas revenues; however, notable cash changes included (i) a decrease of $95.8 million in cash settlements received for matured and early terminations of derivatives, net of premiums paid, (ii) a cash outflow of $6.4 million related to the settlement of our last tranche of performance unit awards in first-quarter 2016 with no comparable amount incurred in the first or second quarter of 2017 and (iii) a decrease in working capital outflows of $1.3 million.

Our operating cash flows are sensitive to a number of variables, the most significant of which are the volatility of oil, NGL and natural gas prices and production levels. Regional and worldwide economic activity, weather, infrastructure, capacity to reach markets, costs of operations, legislation and regulations and other variable factors significantly impact the prices of these commodities. These factors are not within our control and are difficult to predict. For additional information on the impact of changing prices on our financial position, see "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

Cash flows from investing activities

Net cash used in investing activities decreased $66.1 million during the six months ended June 30, 2017 compared to the same period in 2016 and is mainly attributable to (i) proceeds we received from a 2017 divestiture of oil and natural gas properties and (ii) a decrease in contributions made to Medallion partially offset by an increase in capital expenditures of oil and natural gas properties. See Note 3 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional discussion of the divestiture.

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Our net cash used in investing activities for the periods presented is summarized in the table below:

(in thousands)	Six months ended June 30, 2017	2016
Capital expenditures:		
Oil and natural gas properties	$(232,219)	$(197,042)
Midstream service assets	(6,117)	(3,425)
Other fixed assets	(2,683)	(832)
Investment in equity method investee	—	(42,681)
Proceeds from dispositions of capital assets, net of selling costs	63,441	350
Net cash used in investing activities	$(177,578)	$(243,630)

Capital expenditure budget

Our board of directors approved a capital budget of approximately $530.0 million for calendar year 2017, excluding acquisitions and investments in Medallion. If upward pressure in service costs is sustained throughout the remainder of the year, an increase of 5% to 10% to our calendar year 2017 capital budget could result. We do not have a specific acquisition budget since the timing and size of acquisitions cannot be accurately forecasted. In addition, as a 49% owner of Medallion, we do not direct the expansion activities of this entity and therefore cannot predict future capital commitments related to Medallion.

The amount, timing and allocation of capital expenditures are largely discretionary and within management's control. If oil, NGL and natural gas prices decline below our acceptable levels, or costs increase above our acceptable levels, we may choose to defer a portion of our budgeted capital expenditures until later periods to achieve the desired balance between sources and uses of liquidity and prioritize capital projects that we believe have the highest expected returns and potential to generate near-term cash flow. Subject to financing alternatives, we may also increase our capital expenditures significantly to take advantage of opportunities we consider to be attractive. We consistently monitor and may adjust our projected capital expenditures in response to success or lack of success in drilling activities, changes in prices, availability of financing and joint venture opportunities, drilling and acquisition costs, industry conditions, the timing of regulatory approvals, the availability of rigs, service costs, contractual obligations, internally generated cash flow and other factors both within and outside our control. For additional information on the impact of changing prices on our financial position, see "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

Cash flows from financing activities

For the six months ended June 30, 2017, our net cash provided by financing activities was the result of borrowings on our Senior Secured Credit Facility partially offset by (i) payments on our Senior Secured Credit Facility, (ii) the purchase of treasury stock to satisfy employees' tax withholding upon vesting of their stock-based compensation awards and (iii) payments for debt issuance costs as a result of entering into the Fifth Amended and Restated Credit Agreement to our Senior Secured Credit Facility. The aforementioned increase in the purchase of treasury stock is mainly due to the increase of our stock price at the restricted stock awards' vest dates, which is utilized to determine the taxable compensation, compared to our stock price at the restricted stock awards' grant dates, which is utilized to determine the number of shares of restricted stock awards to be granted. For the six months ended June 30, 2016, our primary sources of cash provided by financing activities were borrowings on our Senior Secured Credit Facility and proceeds from our May 2016 Equity Offering, partially offset by payments on our Senior Secured Credit Facility.

Our net cash provided by financing activities for the periods presented is summarized in the table below:

(in thousands)	Six months ended June 30, 2017	2016
Borrowings on Senior Secured Credit Facility	$90,000	$120,000
Payments on Senior Secured Credit Facility	(55,000)	(144,682)
Proceeds from issuance of common stock, net of offering costs	—	119,310
Purchase of treasury stock	(7,597)	(1,541)

Proceeds from exercise of employee stock options	358	67
Payments for debt issuance costs	(4,732)	—
Net cash provided by financing activities	$23,029	$93,154

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Debt

As of June 30, 2017, we were a party only to our Senior Secured Credit Facility and the indentures governing our senior unsecured notes.

As of June 30, 2017, we had $1.4 billion in debt outstanding, $895.0 million available for borrowings under our Senior Secured Credit Facility and $35.0 million in cash on hand for total available liquidity of $930.0 million.

As of August 7, 2017, we had $1.4 billion in debt outstanding, $885.0 million available for borrowings under our Senior Secured Credit Facility and $12.0 million in cash on hand for total available liquidity of $897.0 million.

Senior Secured Credit Facility. As of June 30, 2017, our Senior Secured Credit Facility had a maximum credit amount of $2.0 billion, a borrowing base and an aggregate elected commitment each of $1.0 billion and $105.0 million outstanding.

The borrowing base under our Senior Secured Credit Facility is subject to a semi-annual redetermination based on the lenders' evaluation of our oil, NGL and natural gas reserves. The lenders have the right to call for an interim redetermination of the borrowing base once between any two redetermination dates and in other specified circumstances. The maturity date of the Senior Secured Credit Facility is May 2, 2022, provided that if either of the January 2022 Notes or May 2022 Notes have not been redeemed or refinanced on or prior to the applicable Early Maturity Date, the Senior Secured Credit Facility will mature on such Early Maturity Date.

Principal amounts borrowed under our Senior Secured Credit Facility are payable on the final maturity date with such borrowings bearing interest that is payable, at our election, either on the last day of each fiscal quarter at an Adjusted Base Rate or at the end of one-, two-, three-, six- or, to the extent available, 12-month interest periods (and in the case of six- and 12-month interest periods, every three months prior to the end of such interest period) at an Adjusted London Interbank Offered Rate, in each case, plus an applicable margin, which ranges from 1.0% to 2.0% for Adjusted Base Rate loans and from 2.0% to 3.0% for Adjusted London Interbank Offered Rate loans, based on the ratio of the outstanding revolving credit on our Senior Secured Credit Facility to the elected commitment. We are also required to pay an annual commitment fee based on the unused portion of the bank's commitment of 0.375% to 0.5%.

Our Senior Secured Credit Facility is secured by a first-priority lien on certain of our assets, including oil and natural gas properties constituting at least 85% of the present value of our proved reserves owned now or in the future. Our Senior Secured Credit Facility contains both financial and non-financial covenants. We were in compliance with these covenants as of June 30, 2017.

Senior unsecured notes. The following table presents principal amounts and applicable interest rates for our outstanding senior unsecured notes as of June 30, 2017:

(in millions, except for interest rates)	Principal	Interest rate
January 2022 Notes	$450.0	5.625%
May 2022 Notes	500.0	7.375%
March 2023 Notes	350.0	6.250%
Total Senior Unsecured Notes	$1,300.0	

Refer to Note 4 of our unaudited consolidated financial statements included elsewhere in this Quarterly Report for further discussion of the March 2023 Notes, January 2022 Notes, May 2022 Notes and our Senior Secured Credit Facility.

Obligations and commitments

As of June 30, 2017, our contractual obligations included our March 2023 Notes, January 2022 Notes, May 2022 Notes, Senior Secured Credit Facility, drilling contract commitments, firm sale and transportation commitments, derivative deferred premiums, asset retirement obligations and office and equipment leases. From December 31, 2016 to June 30, 2017, the material changes in our contractual obligations included (i) a decrease of $59.2 million in our firm sale and transportation commitments, (ii) a decrease of $42.0 million on our interest obligations for our senior unsecured notes as semi-annual interest payments were made in January, March and May of 2017, (iii) an increase of $35.0 million outstanding on our Senior Secured Credit Facility, (iv) a decrease of $5.6 million for drilling contract commitments (on contracts other than those on a well-by-well basis) and (v) an increase of $3.7 million in deferred premiums mainly due to new derivative contracts.

Refer to Notes 2, 4, 7, 8 and 11 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional discussion of our contractual obligations.

Non-GAAP financial measure

The non-GAAP financial measure of Adjusted EBITDA, as defined by us, may not be comparable to similarly titled measures used by other companies. Therefore, this non-GAAP measure should be considered in conjunction with net income or loss and other performance measures prepared in accordance with GAAP, such as operating income or loss or cash flow from operating activities. Adjusted EBITDA should not be considered in isolation or as a substitute for GAAP measures, such as net income or loss, operating income or loss or any other GAAP measure of liquidity or financial performance.

Adjusted EBITDA is a non-GAAP financial measure that we define as net income or loss plus adjustments for deferred income tax expense or benefit, depletion, depreciation and amortization, impairment expense, non-cash stock-based compensation, net of amounts capitalized, accretion expense, mark-to-market on derivatives, cash premiums paid for derivatives, interest expense, write-off of debt issuance costs, gains or losses on disposal of assets, income or loss from equity method investee, proportionate Adjusted EBITDA of equity method investee and other non-recurring income and expenses. Adjusted EBITDA provides no information regarding a company’s capital structure, borrowings, interest costs, capital expenditures, working capital movement or tax position. Adjusted EBITDA does not represent funds available for discretionary use because those funds are required for debt service, capital expenditures and working capital, income taxes, franchise taxes and other commitments and obligations. However, our management believes Adjusted EBITDA is useful to an investor in evaluating our operating performance because this measure:

- is widely used by investors in the oil and natural gas industry to measure a company's operating performance without regard to items excluded from the calculation of such term, which can vary substantially from company to company depending upon accounting methods, book value of assets, capital structure and the method by which assets were acquired, among other factors;
- helps investors to more meaningfully evaluate and compare the results of our operations from period to period by removing the effect of our capital structure from our operating structure; and
- is used by our management for various purposes, including as a measure of operating performance, in presentations to our board of directors and as a basis for strategic planning and forecasting.

There are significant limitations to the use of Adjusted EBITDA as a measure of performance, including the inability to analyze the effect of certain recurring and non-recurring items that materially affect our net income or loss, the lack of comparability of results of operations to different companies and the different methods of calculating Adjusted EBITDA reported by different companies. Our measurements of Adjusted EBITDA for financial reporting as compared to compliance under our debt agreements differ.

During the year ended December 31, 2016, we changed the methodology for calculating Adjusted EBITDA by including adjustments for both accretion of asset retirement obligations and our proportionate share of our equity method investee's Adjusted EBITDA. Accordingly, the prior period's Adjusted EBITDA has been modified for comparability.

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The following presents a reconciliation of net income (loss) (GAAP) to Adjusted EBITDA (non-GAAP):

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Net income (loss)	$61,110	$(71,432)	$129,386	$(251,803)
Plus:				
Depletion, depreciation and amortization	38,003	34,177	72,115	75,655
Impairment expense	—	963	—	162,027
Non-cash stock-based compensation, net of amounts capitalized	8,687	6,073	17,911	9,911
Accretion expense	943	860	1,871	1,704
Mark-to-market on derivatives:				
(Gain) loss on derivatives, net	(28,897)	68,518	(65,568)	50,633
Cash settlements received for matured derivatives, net	13,705	47,382	21,156	113,319
Cash settlements received for early terminations of derivatives, net	4,234	—	4,234	80,000
Cash premiums paid for derivatives	(9,987)	(2,413)	(12,094)	(84,263)
Interest expense	23,173	23,512	45,893	47,217
Write-off of debt issuance costs	—	842	—	842
(Gain) loss on disposal of assets, net	(805)	141	(591)	301
Income from equity method investee	(2,471)	(3,696)	(5,539)	(5,994)
Proportionate Adjusted EBITDA of equity method investee[1]	6,601	5,103	12,966	8,787
Adjusted EBITDA	$114,296	$110,030	$221,740	$208,336

(1) Proportionate Adjusted EBITDA of Medallion, our equity method investee, is calculated as follows:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2017	2016	2017	2016
Income from equity method investee	$2,471	$3,696	$5,539	$5,994
Adjusted for proportionate share of:				
Depreciation and amortization	4,130	1,407	7,427	2,793
Proportionate Adjusted EBITDA of equity method investee	$6,601	$5,103	$12,966	$8,787

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Critical accounting policies and estimates

The discussion and analysis of our financial condition and results of operations are based upon our unaudited consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Certain accounting policies involve judgments and uncertainties to such an extent that there is reasonable likelihood that materially different amounts could have been reported under different conditions or if different assumptions had been used. We evaluate our estimates and assumptions on a regular basis. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates and assumptions used in preparation of our unaudited consolidated financial statements. We believe these accounting policies reflect our more significant estimates and assumptions used in preparation of our unaudited consolidated financial statements.

In management's opinion, the more significant reporting areas impacted by our judgments and estimates are (i) the choice of accounting method for oil and natural gas activities, (ii) estimation of oil, NGL and natural gas reserve quantities and standardized measure of future net revenues, (iii) impairment of oil and natural gas properties, (iv) revenue recognition, (v) estimation of income taxes, (vi) asset retirement obligations, (vii) valuation of derivatives and deferred premiums, (viii) valuation of stock-based compensation, (ix) fair value of assets acquired and liabilities assumed in an acquisition and (x) estimates of contingent liabilities. Management's judgments and estimates in these areas are based on information available from both internal and external sources, including engineers, geologists and historical experience in similar matters. Actual results could differ from these estimates as additional information becomes known.

There have been no material changes in our critical accounting policies and procedures during the six months ended June 30, 2017. For our other critical accounting policies and procedures, please see our disclosure of critical accounting policies in "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" of the 2016 Annual Report. Additionally, see Note 2 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for a discussion of additional accounting policies and estimates made by management.

Recent accounting pronouncements

See Note 15 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for information regarding recent accounting pronouncements.

Off-balance sheet arrangements

Currently, we do not have any off-balance sheet arrangements other than operating leases, drilling contracts and firm sale and transportation commitments, which are described in "—Obligations and commitments." See Note 11 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional information.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risk. The term "market risk," in our case, refers to the risk of loss arising from adverse changes in oil, NGL and natural gas prices and in interest rates. The disclosures are not meant to be precise indicators of expected future losses, but rather indicators of how we view and manage our ongoing market risk exposures. All of our market risk sensitive instruments were entered into for hedging purposes, rather than for speculative trading.

Commodity price exposure

Due to the inherent volatility in oil, NGL and natural gas prices, we use derivatives, such as puts, swaps, collars and call spreads to hedge price risk associated with a significant portion of our anticipated production. By removing a portion of the price volatility associated with future production, we expect to reduce, but not eliminate, the potential effects of variability in cash flows from operations due to fluctuations in commodity prices. We have not elected hedge accounting on these derivatives and, therefore, the gains and losses on open positions are reflected in earnings. At each period end, we estimate the fair values of our derivatives using an independent third-party valuation and recognize the associated gain or loss in our unaudited consolidated statements of operations included elsewhere in this Quarterly Report.

The fair values of our derivatives are largely determined by estimates of the forward curves of the relevant price indices. As of June 30, 2017, a 10% change in the forward curves associated with our derivatives would have changed our net positions to the following amounts:

(in thousands)	10% Increase	10% Decrease
Derivatives	$ 17,930	$ 94,646

As of June 30, 2017 and December 31, 2016, the net fair values of our open derivative contracts were $55.1 million and $3.0 million, respectively. Refer to Notes 2.e, 7 and 8.a of our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional disclosures regarding our derivatives.

Interest rate risk

The expected maturity years, carrying amounts and fixed interest rates on our long-term debt as of June 30, 2017 and the Senior Secured Credit Facility's average floating interest rate for the six months ended June 30, 2017 were as follows:

	Expected maturity year	
(in millions except for interest rates)	2022	2023
Senior Secured Credit Facility - floating rate	$ 105.0	$ —
Average interest rate	2.614 %	— %
January 2022 Notes - fixed rate	$ 450.0	$ —
Interest rate	5.625 %	— %
May 2022 Notes - fixed rate	$ 500.0	$ —
Interest rate	7.375 %	— %
March 2023 Notes - fixed rate	$ —	$ 350.0
Interest rate	— %	6.250 %

Counterparty and customer credit risk

As of June 30, 2017, our principal exposures to credit risk were through receivables of (i) $55.8 million from the fair values of our open derivative contracts, (ii) $45.5 million from sales of our oil, NGL and natural gas production that we market to energy marketing companies and refineries, (iii) $11.5 million from sales of purchased oil and other products, (iv) $9.0 million from joint-interest partners and (v) $6.0 million from matured derivatives.

We are subject to credit risk due to the concentration of (i) our oil, NGL and natural gas receivables with several significant customers and (ii) our purchased oil receivable with one customer. On occasion we require our customers to post collateral, and the inability of our significant customers to meet their obligations to us or their insolvency or liquidation may adversely affect our financial results.

We have entered into International Swap Dealers Association Master Agreements ("ISDA Agreements") with each of our derivative counterparties, each of whom is also a lender in our Senior Secured Credit Facility. The terms of the ISDA Agreements provide the non-defaulting or non-affected party the right to terminate the agreement upon the occurrence of certain events of default and termination events by a party and also provide for the marking to market of outstanding positions

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and the offset of the mark to market amounts owed to and by the parties (and in certain cases, the affiliates of the non-defaulting or non-affected party) upon termination.
Refer to Note 10 to our unaudited consolidated financial statements included elsewhere in this Quarterly Report for additional disclosures regarding credit risk.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the period covered by this report, an evaluation of the effectiveness of the design and operation of Laredo's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act), was performed under the supervision and with the participation of Laredo's management, including our principal executive officer and principal financial officer. Based on that evaluation, these officers concluded that Laredo's disclosure controls and procedures were effective as of June 30, 2017. Our disclosure controls and other procedures are designed to provide reasonable assurance that the information required to be disclosed in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to Laredo's management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Evaluation of changes in internal control over financial reporting

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II

Item 1. Legal Proceedings

From time to time we are subject to various legal proceedings arising in the ordinary course of business, including proceedings for which we may not have insurance coverage. While many of these matters involve inherent uncertainty, except with regard to the specific litigation noted below, as of the date hereof, we do not currently believe that any such legal proceedings will have a material adverse effect on our business, financial position, results of operations or liquidity.

On May 3, 2017, Shell Trading (US) Company ("Shell") filed an Original Petition and Request for Disclosure in the District Court of Harris County, Texas, alleging that the crude oil purchase agreement entered into between Shell and Laredo effective October 1, 2016 does not reflect the compensation for Shell that Shell believes was previously agreed to by the parties due to a drafting mistake. Shell seeks reformation of one clause of the crude oil purchase agreement on the grounds of alleged mutual mistake or, in the alternative, unilateral mistake; an award of the amounts Shell alleges it should have been or should be paid under the agreement; court costs and attorneys' fees. We do not believe there was a drafting mistake made in the crude oil purchase agreement. We believe we have substantive defenses and intend to vigorously defend our position. We are unable to determine the outcome or estimate our ultimate exposure, if any, to this litigation at this time.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report, you should carefully consider the risks discussed in our 2016 Annual Report. There have been no material changes in our risk factors from those described in the 2016 Annual Report. The risks described in the 2016 Annual Report are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or future results.

Item 2. Repurchase of Equity Securities

Period	Total number of shares withheld[(1)]	Average price per share	Total number of shares purchased as part of publicly announced plans	Maximum number of shares that may yet be purchased under the plan
April 1, 2017 - April 30, 2017	3,138	$ 14.57	—	—
May 1, 2017 - May 31, 2017	3,107	$ 12.09	—	—
June 1, 2017 - June 30, 2017	1,086	$ 11.91	—	—
Total	7,331			

(1) Represents shares that were withheld by us to satisfy employee tax withholding obligations that arose upon the lapse of restrictions on restricted stock awards.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Disclosure pursuant to Section 13(r) of the Securities Exchange Act of 1934

Pursuant to Section 13(r) of the Exchange Act, we may be required to disclose in our annual and quarterly reports to the SEC, whether we or any of our "affiliates" knowingly engaged in certain activities, transactions or dealings relating to Iran or with certain individuals or entities targeted by United States ("US") economic sanctions. Disclosure is generally required even where the activities, transactions or dealings were conducted in compliance with applicable law. Because the SEC defines the term "affiliate" broadly, it includes any entity under common "control" with us (and the term "control" is also construed broadly by the SEC).

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The description of the activities below has been provided to us by Warburg Pincus LLC ("WP"), affiliates of which: (i) beneficially own more than 10% of our outstanding common stock and/or are members of our board of directors, (ii) beneficially own more than 10% of the equity interests of, and have the right to designate members of the board of directors of Santander Asset Management Investment Holdings Limited ("SAMIH"). SAMIH may therefore be deemed to be under common "control" with us; however, this statement is not meant to be an admission that common control exists.

The disclosure below relates solely to activities conducted by SAMIH and its affiliates. The disclosure does not relate to any activities conducted by us or by WP and does not involve our or WP’s management. Neither Laredo nor WP has had any involvement in or control over the disclosed activities, and neither Laredo nor WP has independently verified or participated in the preparation of the disclosure. Neither Laredo nor WP is representing as to the accuracy or completeness of the disclosure nor do we or WP undertake any obligation to correct or update it.

We understand that one or more SEC-reporting affiliates of SAMIH intends to disclose in its next annual or quarterly SEC report that:

(a) Santander UK plc ("Santander UK") holds two savings accounts and one current account for two customers resident in the United Kingdom ("UK") who are currently designated by the US under the Specially Designated Global Terrorist ("SDGT") sanctions program. Revenues and profits generated by Santander UK on these accounts in the six months ended June 30, 2017 were negligible relative to the overall revenues and profits of Banco Santander SA.

(b) Santander UK holds two frozen current accounts for two UK nationals who are designated by the US under the SDGT sanctions program. The accounts held by each customer have been frozen since their designation and have remained frozen through the six months ended June 30, 2017. The accounts are in arrears (£1,844.73 in debit combined) and are currently being managed by Santander UK Collections & Recoveries department. No revenues or profits were generated by Santander UK on this account in the six months ended June 30, 2017.

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Item 6. Exhibits

Exhibit Number	Description
3.1	Amended and Restated Certificate of Incorporation of Laredo Petroleum Holdings, Inc. (incorporated by reference to Exhibit 3.1 of Laredo's Current Report on Form 8-K (File No. 001-35380) filed on December 22, 2011).
3.2	Certificate of Ownership and Merger, dated as of December 30, 2013 (incorporated by reference to Exhibit 3.1 of Laredo's Current Report on Form 8-K (File No. 001-35380) filed on January 6, 2014).
3.3	Second Amended and Restated Bylaws of Laredo Petroleum, Inc. (incorporated by reference to Exhibit 3.3 of Laredo's Annual Report on Form 10-K (File No. 001-35380) filed on February 17, 2016).
4.1	Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 of Laredo's Registration Statement on Form S-1/A (File No. 333-176439) filed on November 14, 2011).
10.1	Fifth Amended and Restated Credit Agreement, dated as of May 2, 2017, among Laredo Petroleum, Inc., as borrower, Wells Fargo Bank, National Association as administrative agent, and the other financial institutions signatory thereto (incorporated by reference to Exhibit 10.1 of Laredo's Quarterly Report on Form 10-Q (File No. 001-35380) filed on May 4, 2017).
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
32.1**	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18. U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Schema Document.
101.CAL*	XBRL Calculation Linkbase Document.
101.DEF*	XBRL Definition Linkbase Document.
101.LAB*	XBRL Labels Linkbase Document.
101.PRE*	XBRL Presentation Linkbase Document.

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* Filed herewith.

** Furnished herewith.

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SIGNATURES

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

LAREDO PETROLEUM, INC.

Date: August 8, 2017 By: /s/ Randy A. Foutch
Randy A. Foutch
Chairman and Chief Executive Officer
(principal executive officer)

Date: August 8, 2017 By: /s/ Richard C. Buterbaugh
Richard C. Buterbaugh
Executive Vice President and Chief Financial Officer
(principal financial officer)

Date: August 8, 2017 By: /s/ Michael T. Beyer
Michael T. Beyer
Vice President - Controller and Chief Accounting Officer
(principal accounting officer)

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