

PIXELWORKS, INC  
Form 10-Q  
November 04, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2010.

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: 000-30269

# PIXELWORKS, INC.

(Exact name of registrant as specified in its charter)

**OREGON**  
(State or other jurisdiction of incorporation)

**91-1761992**  
(I.R.S. Employer Identification No.)

**224 Airport Parkway, Suite 400**

**San Jose, CA 95110**

**(408) 200-9200**

(Address of principal executive offices, including zip code,  
and 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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the last 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Number of shares of Common Stock outstanding as of October 29, 2010: 13,564,942

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**PIXELWORKS, INC.**

**FORM 10-Q**

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2010**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****PIXELWORKS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)****(Unaudited)**

	<b>September 30, 2010</b>	<b>December 31, 2009</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 16,378	\$ 17,797
Short-term marketable securities	12,602	9,822
Accounts receivable, net	5,319	5,619
Inventories, net	5,466	6,158
Prepaid expenses and other current assets	2,636	2,265
Total current assets	42,401	41,661
Long-term marketable securities	2,265	3,240
Property and equipment, net	5,809	5,121
Other assets, net	5,358	5,006
Acquired intangible assets, net		1,050
Total assets	\$ 55,833	\$ 56,078
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 6,547	\$ 7,680
Accrued liabilities and current portion of long-term liabilities	9,679	8,513
Current portion of income taxes payable		109
Debt currently payable	15,779	
Total current liabilities	32,005	16,302
Long-term liabilities, net of current portion	2,611	1,462
Income taxes payable, net of current portion	3,738	9,462
Long-term debt		15,779
Total liabilities	38,354	43,005
Commitments and contingencies (Note 12)		
Shareholders' equity:		
Preferred stock		
Common stock	335,892	334,849

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Accumulated other comprehensive income	856	1,087
Accumulated deficit	(319,269)	(322,863)
Total shareholders' equity	17,479	13,073
Total liabilities and shareholders' equity	\$ 55,833	\$ 56,078

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****PIXELWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(Unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Revenue, net	\$ 18,027	\$ 16,732	\$ 55,384	\$ 41,725
Cost of revenue (1)	9,733	9,391	29,787	23,455
Gross profit	8,294	7,341	25,597	18,270
Operating expenses:				
Research and development (2)	5,612	4,870	16,505	14,178
Selling, general and administrative (3)	3,685	3,011	11,435	10,224
Restructuring		104	94	205
Total operating expenses	9,297	7,985	28,034	24,607
Loss from operations	(1,003)	(644)	(2,437)	(6,337)
Gain on sale of marketable securities	316		660	
Interest expense	(125)	(124)	(372)	(520)
Interest income	17	53	49	226
Amortization of debt issuance costs	(19)	(19)	(55)	(106)
Gain on repurchase of long-term debt, net				12,860
Interest and other income (loss), net	189	(90)	282	12,460
Income (loss) before income taxes	(814)	(734)	(2,155)	6,123
Provision (benefit) for income taxes	(821)	156	(5,749)	(1,103)
Net income (loss)	\$ 7	\$ (890)	\$ 3,594	\$ 7,226
Net income (loss) per share:				
Basic	\$ 0.00	\$ (0.07)	\$ 0.27	\$ 0.54
Diluted	\$ 0.00	\$ (0.07)	\$ 0.25	\$ 0.53
Weighted average shares outstanding:				
Basic	13,465	13,307	13,417	13,316
Diluted	14,335	13,307	14,370	13,549

(1) Includes:

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Amortization of acquired developed technology	\$	\$	573	\$	1,050	\$	1,763
Stock-based compensation		17	4		41		14
Additional amortization of non-cancelable prepaid royalty			62		5		180
Restructuring							43
(2) Includes stock-based compensation		120	99		309		325
(3) Includes stock-based compensation		225	92		500		449

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****PIXELWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	Nine Months Ended September 30,	
	2010	2009
<b>Cash flows from operating activities:</b>		
Net income	\$ 3,594	\$ 7,226
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Gain on repurchase of long-term debt, net		(12,860)
Reversal of uncertain tax positions	(5,957)	(1,815)
Depreciation and amortization	3,328	3,441
Amortization of acquired intangible assets	1,050	1,763
Stock-based compensation	850	788
Gain on sale of marketable securities	(660)	
Other non-cash tax benefits	(27)	
Amortization on short-term marketable securities	68	26
Amortization of debt issuance costs	55	106
(Gain) loss on asset disposals	(4)	6
Deferred income tax benefit		(207)
Other	43	38
Changes in operating assets and liabilities:		
Accounts receivable, net	300	455
Inventories, net	692	134
Prepaid expenses and other current and long-term assets, net	1,024	434
Accounts payable	(1,797)	2,194
Accrued current and long-term liabilities	373	(2,851)
Income taxes payable	123	440
<b>Net cash provided by (used in) operating activities</b>	<b>3,055</b>	<b>(682)</b>
<b>Cash flows from investing activities:</b>		
Purchases of marketable securities	(13,567)	(8,877)
Proceeds from sales and maturities of marketable securities	12,150	10,300
Purchases of property and equipment	(1,171)	(702)
Purchases of other assets	(290)	(27)
Proceeds from sales of property and equipment	5	
<b>Net cash provided by (used in) investing activities</b>	<b>(2,873)</b>	<b>694</b>
<b>Cash flows from financing activities:</b>		
Payments on asset financings	(1,794)	(1,532)
Proceeds from issuances of common stock	193	14
Repurchase of long-term debt		(31,532)



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Repurchase of common stock		(167)
Net cash used in financing activities	(1,601)	(33,217)
Net change in cash and cash equivalents	(1,419)	(33,205)
Cash and cash equivalents, beginning of period	17,797	53,149
Cash and cash equivalents, end of period	\$ 16,378	\$ 19,944

See accompanying notes to condensed consolidated financial statements.

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**PIXELWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except share and per share data)**

**(Unaudited)**

**NOTE 1: BASIS OF PRESENTATION**

**Nature of Business**

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications and hold 130 patents related to the visual display of digital image data. Our solutions enable manufacturers of digital display and projection devices, such as large-screen flat panel displays and digital front projectors, to differentiate their products with a consistently high level of video quality, regardless of the content's source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

**Condensed Consolidated Financial Statements**

These condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) have been condensed or omitted pursuant to such regulations, although we believe that the disclosures provided are adequate to prevent the information presented from being misleading.

The financial information included herein for the three and nine month periods ended September 30, 2010 and 2009 is unaudited; however, such information reflects all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows of the Company for these interim periods. The financial information as of December 31, 2009 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2009, included in Item 8 of our Annual Report on Form 10-K, filed with the SEC on March 10, 2010, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three and nine month periods ended September 30, 2010 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2010.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and judgments that affect amounts reported in the financial statements and accompanying notes. Our significant estimates and judgments include those related to product returns, warranty obligations, bad debts, inventories, property and equipment, intangible assets, impairment of long-lived assets, valuation of investments, amortization of prepaid royalties, valuation of share-based payments, income taxes, litigation and other contingencies. The actual results experienced could differ materially from our estimates.

**Table of Contents****Reclassifications**

Certain reclassifications have been made to the 2009 condensed consolidated financial statements to conform with the 2010 presentation.

**NOTE 2: BALANCE SHEET COMPONENTS****Marketable Securities** See Note 3**Accounts Receivable, Net**

Accounts receivable are recorded at invoiced amount and do not bear interest when recorded or accrue interest when past due. Accounts receivable are stated net of an allowance for doubtful accounts, which is maintained for estimated losses that may result from the inability of our customers to make required payments. Accounts receivable consists of the following:

	September 30, 2010	December 31, 2009
Accounts receivable, gross	\$ 5,755	\$ 6,047
Less: allowance for doubtful accounts	(436)	(428)
Accounts receivable, net	\$ 5,319	\$ 5,619

The following is the change in our allowance for doubtful accounts:

	Nine Months Ended September 30,	
	2010	2009
Balance at beginning of period	\$ 428	\$ 542
Additions charged (reductions credited)	8	(98)
Accounts written-off, net of recoveries		
Balance at end of period	\$ 436	\$ 444

**Inventories, Net**

Inventories consist of finished goods and work-in-process, and are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market (net realizable value), net of a reserve for slow-moving and obsolete items.

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Inventories consist of the following:

	September 30, 2010	December 31, 2009
Finished goods	\$ 3,200	\$ 2,888
Work-in-process	4,234	5,410
Inventory, gross	7,434	8,298
Inventory reserves	(1,968)	(2,140)
Inventory, net	\$ 5,466	\$ 6,158

Inventory, gross reflects lower of cost or market write-downs of \$771 for the nine months ended September 30, 2010.

The following is the change in our inventory reserves:

	Nine Months Ended September 30,	
	2010	2009
Balance at beginning of period	\$ 2,140	\$ 4,994
New provision	476	433
Sales of previously reserved inventory	(84)	(647)
Net provision (benefit)	392	(214)
Final scrap of previously reserved inventory	(564)	(1,904)
Balance at end of period	\$ 1,968	\$ 2,876

The provision for the nine months ended September 30, 2010 and 2009 consists of reserves for slow moving and obsolete items which we do not currently expect to be able to sell or otherwise use. While it is possible that a customer will decide in the future to purchase inventory items for which a full or partial reserve has been made, it is not possible for us to predict if or when this may happen, or the amount of gain we may recognize. If such sales occur, we do not expect that they will have a material effect on gross profit margin.

**Property and Equipment, Net**

Property and equipment consists of the following:

	September 30, 2010	December 31, 2009
Gross carrying amount	\$ 21,739	\$ 18,472
Less: accumulated depreciation and amortization	(15,930)	(13,351)
Property and equipment, net	\$ 5,809	\$ 5,121



**Table of Contents****Acquired Intangible Assets, Net**

Acquired intangible assets consist of the following developed technology:

	September 30, 2010	December 31, 2009
Gross carrying amount	\$ 19,170	\$ 19,170
Less: accumulated amortization	(19,170)	(18,120)
Acquired intangible assets, net	\$	\$ 1,050

**Accrued Liabilities and Current Portion of Long-Term Liabilities**

Accrued liabilities and current portion of long-term liabilities consist of the following:

	September 30, 2010	December 31, 2009
Current portion of accrued liabilities for asset financings	\$ 2,701	\$ 2,068
Accrued payroll and related liabilities	2,551	2,279
Accrued commissions and royalties	1,139	853
Reserve for warranty returns	547	304
Accrued interest payable	392	257
Accrued costs related to restructuring	198	190
Other	2,151	2,562
	\$ 9,679	\$ 8,513

The following is the change in our reserves for warranty returns:

	Nine Months Ended September 30,	
	2010	2009
Reserve for warranty returns:		
Balance at beginning of period	\$ 304	\$ 593
Provision	688	299
Charge-offs	(445)	(540)
Balance at end of period	\$ 547	\$ 352

**Debt currently payable**

In 2004, we issued \$150,000 of 1.75% convertible subordinated debentures (the debentures) due 2024. In 2006, we repurchased and retired \$10,000 principal amount of the debentures and in 2008, we repurchased and retired \$79,366 principal amount of the debentures. In 2009, we repurchased and retired \$44,855 principal amount of the debentures for \$31,532 in cash. We recognized a net gain on the repurchase of \$12,860, which included a \$13,357 discount, offset by a write-off of debt issuance costs of \$463 and other fees of \$34.

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As of September 30, 2010, \$15,779 of the debentures are outstanding. The remaining debentures are convertible, under certain circumstances, into our common stock at a conversion rate of 13.6876 shares of common stock per \$1 principal amount of debentures for a total of 215,977 shares. This is equivalent to a conversion price of approximately \$73.06 per share. The debentures are convertible if (a) our stock trades above 130% of the conversion price for 20 out of 30 consecutive trading days during any calendar quarter, (b) the debentures trade at an amount less than or equal to 98% of the if-converted value of the debentures for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other specified corporate transactions. If our debentures are converted into common stock, they can not be settled in cash or other assets.

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We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the \$15,779 debentures outstanding at each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019, at a purchase price equal to 100% of the principal amount plus accrued and unpaid interest. As of September 30, 2010 we have classified the debentures as current liabilities as we expect the holders to require us to purchase all of the debentures on May 15, 2011. The debentures are unsecured obligations and are subordinated in right of payment to all of our existing and future senior debt.

**Long-Term Liabilities, Net of Current Portion**

Long-term liabilities, net of current portion, consist of the following:

	September 30, 2010	December 31, 2009
Accrued liabilities for asset financings	\$ 1,786	\$ 553
Deferred rent	350	494
Accrued costs related to restructuring	141	218
Payroll and related liabilities	133	136
Other	201	61
	\$ 2,611	\$ 1,462

**NOTE 3: MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS**

As of September 30, 2010 and December 31, 2009, all of our marketable securities are classified as available-for-sale and consist of the following:

	Cost	Unrealized Gain (Loss)	Fair Value
<b>Short-term marketable securities:</b>			
As of September 30, 2010:			
U.S. government agencies debt securities	\$ 9,133	\$ 5	\$ 9,138
Commercial paper	2,347		2,347
Corporate debt securities	1,117		1,117
	\$ 12,597	\$ 5	\$ 12,602
As of December 31, 2009:			
U.S. government agencies debt securities	\$ 6,286	\$ (3)	\$ 6,283
Commercial paper	2,996		2,996
Corporate debt security	542	1	543
	\$ 9,824	\$ (2)	\$ 9,822



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	Cost	Unrealized Gain	Fair Value
<b>Long-term marketable securities:</b>			
As of September 30, 2010:			
Equity securities	\$ 1,346	\$ 919	\$ 2,265
As of December 31, 2009:			
Equity securities	\$ 2,110	\$ 1,130	\$ 3,240

Unrealized holding gains and losses are recorded in accumulated other comprehensive income, a component of shareholders' equity, in the condensed consolidated balance sheets. During the quarter ended September 30, 2010, we sold an available-for-sale short-term marketable security and a portion of our long-term marketable securities for gross proceeds of \$1,799 and \$869 respectively, and gross realized gains of \$0 and \$316 respectively. We determined the cost of securities sold using specific identification. Net unrealized holding gains of \$469 and \$409 on available-for-sale marketable securities were reclassified out of accumulated other comprehensive income for the three and nine month periods ended September 30, 2010, respectively.

**Fair Value Measurements**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Three levels of inputs may be used to measure fair value:

- Level 1: Valuations based on quoted prices in active markets for identical assets and liabilities.
- Level 2: Valuations based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3: Valuations based on unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

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The following tables present information about our assets measured at fair value on a recurring basis in the condensed consolidated balance sheets as of September 30, 2010 and December 31, 2009:

	Level 1	Level 2	Level 3	Total
<b>As of September 30, 2010:</b>				
Money market funds	\$ 13,919	\$	\$	\$ 13,919
Certificates of deposit	200			200
U.S. government agencies debt securities		9,138		9,138
Commercial paper		2,947		2,947
Corporate debt securities		1,117		1,117
Long-term marketable securities	2,265			2,265
<b>Total</b>	<b>\$ 16,384</b>	<b>\$ 13,202</b>	<b>\$</b>	<b>\$ 29,586</b>
<b>As of December 31, 2009:</b>				
Money market funds	\$ 16,873	\$	\$	\$ 16,873
Certificates of deposit	200			200
U.S. government agencies debt securities		6,283		6,283
Commercial paper		2,996		2,996
Corporate debt security		543		543
Long-term marketable securities	3,240			3,240
<b>Total</b>	<b>\$ 20,313</b>	<b>\$ 9,822</b>	<b>\$</b>	<b>\$ 30,135</b>

We primarily use the market approach to determine the fair value of our financial assets.

The fair value of our current assets and liabilities, excluding debt currently payable, approximates the carrying value due to the short-term nature of these balances. As of September 30, 2010 the fair value and carrying value of our debt currently payable is \$15,463 and \$15,779, respectively. The fair value estimate is based on the most recent sales of our debt. We have currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with GAAP.

**NOTE 4: RESTRUCTURING**

In December 2008, we initiated a restructuring plan to reduce our operating expenses in response to decreases in current and forecasted revenue which resulted primarily from the global economic crisis. This plan reduced operations, research and development and administrative headcount in our San Jose, Taiwan and China offices and was completed during the second quarter of 2009.

In November 2006, we initiated a restructuring plan to reduce operating expenses. This plan included consolidation of our operations in order to reduce compensation and rent expense. As part of this plan we also narrowed and redefined our product development strategy which resulted in the write-off of intellectual property assets, tooling, software development tools and charges for related non-cancelable contracts. Although this plan was completed in the fourth quarter of 2008, lease termination costs were recorded in 2010 and 2009 due to decreases in estimated future sublease income and related professional fees.

Total cumulative restructuring expense recorded in our statements of operations related to the restructuring plans initiated in November 2006 and December 2008 is comprised of net write-off of assets and reversal of related liabilities of \$15,296, termination and retention benefits of \$8,133, consolidation of leased space of \$2,192, a contract termination fee of \$1,693, payments on non-cancelable contracts of \$827 and other expenses of \$88.

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Accrued expenses related to the restructuring plans are included in current and non-current accrued liabilities in the condensed consolidated balance sheets. The following is a summary of the change in accrued liabilities related to our restructuring plans during the nine months ended September 30, 2010:

	December 31, 2009	Expensed	Payments	September 30, 2010
Lease termination costs	\$ 408	\$ 94	\$ (163)	\$ 339

The remaining liability for lease termination costs was accrued under the November 2006 plan and will be paid in cash over the remaining lease terms.

**NOTE 5: INCOME TAXES**

The benefit for income taxes recorded for the third quarter of 2010 was primarily due to a benefit of \$673 for the reversal of previously recorded tax contingencies due to the expiration of applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. The provision for income taxes recorded for the third quarter of 2009 included current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions.

The benefit for income taxes recorded for the first nine months of 2010 and 2009 of \$5,957 and \$1,815, respectively, were primarily due to the reversal of previously recorded tax contingencies due to the expiration of the applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions.

As of September 30, 2010, we continued to provide a full valuation allowance against essentially all of our U.S. and Canadian net deferred tax assets as we do not believe that it is more likely than not that we will realize a benefit from those assets. We have not recorded a valuation allowance against our other foreign net deferred tax assets as we believe that it is more likely than not that we will realize a benefit from those assets.

As of September 30, 2010 and December 31, 2009, the amount of our uncertain tax positions was a liability of \$3,738 and \$9,462, respectively. A number of years may elapse before an uncertain tax position is resolved by settlement or statute of limitation. Settlement of any particular position could require the use of cash. If the uncertain tax positions we have accrued for are sustained by the taxing authorities in our favor, the reduction of the liability will reduce our effective tax rate. We reasonably expect reductions in the liability for unrecognized tax benefits of approximately \$1,189 within the next twelve months due to the expiration of statutes of limitation in foreign jurisdictions. We recognize interest and penalties related to uncertain tax positions in income tax expense in our consolidated statements of operations.

**Table of Contents****NOTE 6: COMPREHENSIVE INCOME (LOSS)**

Total comprehensive income (loss) was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income (loss)	\$ 7	\$ (890)	\$ 3,594	\$ 7,226
Reclassification of unrealized gain upon sale of available-for-sale securities	(469)		(409)	
Unrealized gain (loss) on available-for-sale securities	(218)	(167)	205	186
Tax effect of unrealized gain (loss) on available-for-sale securities	102		(27)	
<b>Total comprehensive income (loss)</b>	<b>\$ (578)</b>	<b>\$ (1,057)</b>	<b>\$ 3,363</b>	<b>\$ 7,412</b>

**NOTE 7: EARNINGS PER SHARE**

Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding. Diluted weighted average shares outstanding include the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period.

Potentially dilutive common shares from employee equity incentive plans are determined by applying the treasury stock method to the assumed exercise of outstanding stock options, the assumed vesting of outstanding restricted stock awards and units, and the assumed issuance of common stock under the stock purchase plan. Potentially dilutive common shares issuable upon conversion of our convertible subordinated debentures are computed using the if-converted-method.

The following schedule reconciles the computation of basic net income (loss) per share and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income (loss) used in basic net income (loss) per share	\$ 7	\$ (890)	\$ 3,594	\$ 7,226
Basic weighted average shares outstanding	13,465	13,307	13,417	13,316
Dilutive effect of employee equity incentive plans	870		953	233
Diluted weighted average shares outstanding	14,335	13,307	14,370	13,549
<b>Net income (loss) per common share:</b>				
Basic	\$ 0.00	\$ (0.07)	\$ 0.27	\$ 0.54
Diluted	\$ 0.00	\$ (0.07)	\$ 0.25	\$ 0.53



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The following weighted average shares were excluded from the calculation of diluted weighted average shares outstanding as their effect on net income would have been anti-dilutive (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Employee equity incentive plans	1,834	1,261	1,608	1,580
Conversion of debentures	216	216	216	404

**NOTE 8: SUPPLEMENTAL CASH FLOW INFORMATION**

Supplemental disclosure of cash flow information is as follows:

	Nine Months Ended September 30,	
	2010	2009
Cash paid during the period for:		
Interest	\$ 237	\$ 469
Income taxes	111	159
Non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	\$ 4,210	\$ 2,576

**NOTE 9: SHAREHOLDERS' EQUITY**

On May 18, 2010 our shareholders approved the adoption of the 2010 Pixelworks, Inc. Employee Stock Purchase Plan (the "ESPP") for U.S. employees and for certain foreign subsidiary employees. The ESPP provides for separate offering periods commencing on February 1 and August 1, with the first offering period beginning August 1, 2010. Each offering period continues for a period of 18 months with purchases every six months. Each eligible employee may purchase up to three thousand shares of stock on each purchase date, with a maximum annual purchase amount of \$25,000. The purchase price is equal to 85% of the lesser of the fair market value of the shares on the offering date or on the purchase date. A total of 1,300,000 shares of common stock have been reserved for issuance under the ESPP.

The fair value of purchase rights under the ESPP are estimated using the Black-Scholes option valuation model and expensed straight-line over the expected service period, which is generally the 18 month offering period. The Black-Scholes option valuation is affected by our estimates of the risk free rate, our expected dividend yield, the expected term of the purchase rights and expected volatility of our common shares over the expected term.

**NOTE 10: SEGMENT INFORMATION**

We have identified a single operating segment: the design and development of integrated circuits for use in electronic display devices. A majority of our assets are located in the U.S.

**Table of Contents****Geographic Information**

Revenue by geographic region, attributed to countries based on the domicile of the customer, was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Japan	\$ 12,014	\$ 10,087	\$ 34,695	\$ 22,741
Taiwan	2,747	4,025	10,044	9,588
Europe	884	516	2,553	2,151
Korea	648	722	2,093	2,486
U.S.	635	324	2,394	1,328
China	165	584	945	1,460
Other	934	474	2,660	1,971
	\$ 18,027	\$ 16,732	\$ 55,384	\$ 41,725

**Significant Customers**

The percentage of revenue attributable to our distributors, top five end customers, and individual distributors or end customers that represented more than 10% of revenue in at least one of the periods presented, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Distributors:				
All distributors	65%	54%	59%	51%
Distributor A	49%	39%	42%	36%
End Customers: <sup>(1)</sup>				
Top five end customers	59%	59%	58%	55%
End customer A	18%	21%	20%	18%
End customer B	12%	9%	12%	10%
End customer C	11%	15%	11%	11%
End customer D	10%	4%	9%	6%

<sup>(1)</sup> End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors.

The following accounts represented 10% or more of total accounts receivable in at least one of the periods presented:

	September 30, 2010	December 31, 2009
Account A	35%	22%
Account B	19%	34%
Account C	12%	11%





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### **NOTE 11: RISKS AND UNCERTAINTIES**

#### **Concentration of Suppliers**

We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. We rely on three third-party foundries to produce all of our wafers and three assembly and test vendors for completion of finished products. We do not have any long-term agreements with any of these suppliers. In light of these dependencies, it is reasonably possible that failure to perform by one of these suppliers could have a severe impact on our results of operations. Additionally, the concentration of these vendors within the People's Republic of China and Taiwan increases our risk of supply disruption due to natural disasters, economic instability, political unrest or other regional disturbances.

#### **Risk of Technological Change**

The markets in which we compete, or seek to compete, are subject to rapid technological change, frequent new product introductions, changing customer requirements for new products and features and evolving industry standards. The introduction of new technologies and the emergence of new industry standards could render our products less desirable or obsolete, which could harm our business.

#### **Concentrations of Credit Risk**

Financial instruments that potentially subject us to concentrations of credit risk consist of cash equivalents, short- and long-term marketable securities and accounts receivable. We limit our exposure to credit risk associated with cash equivalent and marketable security balances by placing our funds in various high-quality securities and limiting concentrations of issuers and maturity dates. We limit our exposure to credit risk associated with accounts receivable by carefully evaluating creditworthiness before offering terms to customers.

### **NOTE 12: COMMITMENTS AND CONTINGENCIES**

#### **Indemnifications**

Certain of our agreements include limited indemnification provisions for claims from third-parties relating to our intellectual property. It is not possible for us to predict the maximum potential amount of future payments or indemnification costs under these or similar agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each particular agreement. We have not made any payments under these agreements in the past, and as of September 30, 2010, we have not incurred any material liabilities arising from these indemnification obligations. In the future, however, such obligations could immediately impact our results of operations but are not expected to materially affect our business.

#### **Legal Proceedings**

Effective October 1, 2010, the Company and Intersil Corporation ( Intersil ) entered into an agreement to resolve the previously disclosed dispute between the parties (Superior Court of the State of California for the County of Santa Clara, Case No. 1-10-CV-164894) (the Action ). The agreement includes an amendment to the license agreement between Intersil and the Company reducing the total amount of remaining prepaid royalties to be paid by the Company from \$1,250 to \$900. Intersil and the Company each also agreed to dismiss with prejudice their respective claims against the other party in the Action and the Action was dismissed, with prejudice, on October 6, 2010.

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In addition to the specific issue described above, we are subject to legal matters that arise from time to time in the ordinary course of our business. Although we currently believe that resolving such matters, individually or in the aggregate, will not have a material adverse effect on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties and our view of these matters may change in the future.

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Forward-looking Statements**

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that are based on current expectations, estimates, beliefs, assumptions and projections about our business. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and variations of such words and similar expressions are intended to identify such forward-looking statements. Such forward-looking statements include the disclosure contained under the caption Results of Operations Business Outlook below. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict and which may cause actual outcomes and results to differ materially from what is expressed or forecasted in such forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in Part II, Item 1A of this Quarterly Report on Form 10-Q. These forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q. If we do update or correct one or more forward-looking statements, you should not conclude that we will make additional updates or corrections with respect thereto or with respect to other forward-looking statements. Except where the context otherwise requires, in this Quarterly Report on Form 10-Q, the Company, Pixelworks, we, us and our refer to Pixelworks, Inc., an Oregon corporation, where appropriate, its subsidiaries.

#### **Overview**

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications and hold 130 patents related to the visual display of digital image data. Our solutions enable manufacturers of digital display and projection devices, such as large-screen flat panel displays and digital front projectors, to differentiate their products with a consistently high level of video quality, regardless of the content's source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

#### **Factors Affecting Results of Operations and Financial Condition**

##### *General Market Conditions*

Financial, commercial and consumer markets experienced significant disruption during the last quarter of 2008 and throughout 2009 which adversely affected our results of operations during 2009. We experienced a significant decrease in revenue during the first and second quarters of 2009 as consumer demand decreased and our customers reduced their inventory levels in response to economic uncertainty and lack of visibility regarding expected future sales. Although the macroeconomic environment and our

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business appear to have stabilized during the second half of 2009 and during the first nine months of 2010, consumer confidence and spending remain cautious and we are unable to predict how the uncertainty in the global economic environment may impact our future results of operations and financial position.

**Results of Operations****Revenue, net**

Revenue, net for the three and nine month periods ended September 30, 2010 and 2009, was as follows (dollars in thousands):

	Three months ended September 30,			Nine months ended September 30,		
	2010	2009	% change	2010	2009	% change
Revenue, net	\$ 18,027	\$ 16,732	8%	\$ 55,384	\$ 41,725	33%

Net revenue increased \$1.3 million, or 8%, from the third quarter of 2009 to the third quarter of 2010. The increase was attributable to a 2% increase in units sold and a 6% increase in average selling price. The increase in revenue resulted primarily from increased sales of our new digital projector products, including increased sales in the DLP segment of the digital projector market. These increases were partially offset by a decrease in units sold into the television and panel market due to new product transactions.

Net revenue increased \$13.7 million, or 33%, from the first nine months of 2009 to the first nine months of 2010. The increase was attributable to a 25% increase in units sold and a 6% increase in average selling price. The increase in units sold resulted primarily from increased sales into the digital projector market as customer demand strengthened during the first nine months of 2010 as a result of improvements in the world wide economy. The increase in the digital projector market was partially offset by decreased sales of legacy products that we acquired in conjunction with our acquisition of Equator Technologies, Inc. during the first nine months of 2010 compared to the first nine months of 2009.

**Table of Contents**Cost of revenue and gross profit

Cost of revenue and gross profit for the three month periods ended September 30, 2010 and 2009, were as follows (dollars in thousands):

	Three months ended September 30,			
	2010	% of revenue	2009	% of revenue
Direct product costs and related overhead <sup>1</sup>	\$ 9,403	52%	\$ 8,679	52%
Amortization of acquired intangible assets		0	573	3
Inventory charges <sup>2</sup>	313	2	73	0
Other cost of revenue <sup>3</sup>	17	0	66	0
<b>Total cost of revenue</b>	<b>\$ 9,733</b>	<b>54%</b>	<b>\$ 9,391</b>	<b>56%</b>
<b>Gross profit</b>	<b>\$ 8,294</b>	<b>46%</b>	<b>\$ 7,341</b>	<b>44%</b>

<sup>1</sup> Includes purchased materials, assembly, test, labor, employee benefits, warranty expense and royalties.

<sup>2</sup> Includes the net provision for inventory reserves and lower of cost or market write-downs.

<sup>3</sup> Includes stock based compensation and additional amortization of non-cancelable prepaid royalty.

Cost of revenue decreased to 54% of total revenue in the third quarter of 2010, down from 56% of total revenue in the third quarter of 2009. The decrease is primarily due to the elimination of amortization expense for acquired intangible assets that were fully amortized as of June 30, 2010. The decrease is partially offset by an increase in inventory charges as we continue to transition customers to our next generation products. Direct product cost as a percentage of revenue remained flat in the third quarter of 2010 as the result of cost reductions on our new products, offset by a higher mix of our new products which have higher material costs than our legacy products.

Cost of revenue and gross profit for the nine month periods ended September 30, 2010 and 2009, were as follows (dollars in thousands):

	Nine months ended September 30,			
	2010	% of revenue	2009	% of revenue
Direct product costs and related overhead <sup>1</sup>	\$ 27,528	50%	\$ 21,669	52%
Amortization of acquired intangible assets	1,050	2	1,763	4
Inventory charges <sup>2</sup>	1,163	2	(214)	(1)
Other cost of revenue <sup>3</sup>	46	0	237	1
<b>Total cost of revenue</b>	<b>\$ 29,787</b>	<b>54%</b>	<b>\$ 23,455</b>	<b>56%</b>
<b>Gross profit</b>	<b>\$ 25,597</b>	<b>46%</b>	<b>\$ 18,270</b>	<b>44%</b>

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<sup>1</sup> Includes purchased materials, assembly, test, labor, employee benefits, warranty expense and royalties.

<sup>2</sup> Includes the net provision (benefit) for inventory reserves and lower of cost or market write-downs.

<sup>3</sup> Includes stock based compensation and additional amortization of non-cancelable prepaid royalty.

Cost of revenue decreased to 54% of total revenue in the first nine months of 2010, down from 56% of total revenue in the first nine months of 2009. The percentage decrease resulted from a decrease in direct product cost due to improved overhead cost absorption and favorable changes in the mix of products sold. The decrease is also partially due to a decrease in amortization expense for acquired intangibles assets that were fully amortized as of June 30, 2010. The decreases are partially offset by an increase in inventory charges as we transitioned customers to our next generation products.

**Table of Contents****Research and development**

Research and development expense includes compensation and related costs for personnel, development-related expenses including non-recurring engineering and fees for outside services, depreciation and amortization, expensed equipment, facilities and information technology expense allocations and travel and related expenses.

Research and development expense for the three month periods ended September 30, 2010 and 2009, was as follows (dollars in thousands):

	Three months ended September 30,		2010 v 2009	
	2010	2009	\$ change	% change
Research and development	\$ 5,612	\$ 4,870	\$ 742	15%

Research and development expense increased \$0.7 million, or 15%, from the third quarter of 2009 to the third quarter of 2010 primarily due to the following:

Compensation expense increased \$0.3 million as the result of:

the elimination of a company-wide 10% salary reduction that was in effect during the third quarter of 2009; and

an increase in the number of research and development employees from the third quarter of 2009 to the third quarter of 2010.

Non-recurring engineering and outside services increased \$0.2 million;

Depreciation and amortization expense, software and software maintenance expense and expensed equipment increased \$0.1 million. Research and development expense for the nine month periods ended September 30, 2010 and 2009, was as follows (dollars in thousands):

	Nine months ended September 30,		2010 v 2009	
	2010	2009	\$ change	% change
Research and development	\$ 16,505	\$ 14,178	\$ 2,327	16%

Research and development expense increased \$2.3 million, or 16%, from the first nine months of 2009 to the first nine months of 2010 primarily due to the following:

Compensation expense increased \$0.9 million as the result of:

the elimination of a company-wide 10% salary reduction that was in effect during the second and third quarters of 2009; and

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an increase in the number of research and development employees from the first nine months of 2009 to the first nine months of 2010.

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Non-recurring engineering and outside services increased \$0.6 million as a result of increased products in development during the first nine months of 2010.

Depreciation and amortization expense, software maintenance expense and expensed equipment and software increased \$0.5 million as a result of an increase in engineering software tools, and our purchase of additional equipment during the first nine months of 2010.

**Selling, general and administrative**

Selling, general and administrative expense includes compensation and related costs for personnel, sales commissions, allocations for facilities and information technology expenses, travel, outside services and other general expenses incurred in our sales, marketing, customer support, management, legal and other professional and administrative support functions.

Selling, general and administrative expense for the three and nine month periods ended September 30, 2010 and 2009, was as follows (dollars in thousands):

	Three months ended September 30,			Nine months ended September 30,		
	2010	2009	% change	2010	2009	% change
Selling, general and administrative	\$ 3,685	\$ 3,011	22%	\$ 11,435	\$ 10,224	12%

Selling, general and administrative expense increased \$0.7 million or 22%, from the third quarter of 2009 to the third quarter of 2010 and \$1.2 million or 12%, from the first nine months of 2009 to the first nine months of 2010. The increase during the 2010 periods is primarily due to an increase in compensation expense as the result of the elimination of a company-wide salary reduction in effect during the second and third quarters of 2009 and an increase in the number of employees during 2010. The increase is partially offset by the reversal of the management bonus accrual in the third quarter 2010 as a result of changes to our estimated annual results.

**Restructuring**

We recorded restructuring expense in cost of revenue and operating expenses. Restructuring expense for the three and nine month periods ended September 30, 2010 and 2009, was comprised of the following amounts (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Termination benefits <sup>1</sup>	\$	\$	\$	\$ 118
Consolidation of leased space <sup>2</sup>		104	94	130
<b>Total restructuring expenses</b>	\$	\$ 104	\$ 94	\$ 248
Included in cost of revenue	\$	\$	\$	\$ 43
Included in operating expenses		104	94	205

<sup>1</sup> Includes severance payments for terminated employees.



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- <sup>2</sup> Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and related professional fees.

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In December 2008, we initiated a restructuring plan to reduce our operating expenses in response to decreases in current and forecasted revenue which resulted from global economic uncertainty. The plan reduced operations, research and development and administrative headcount in our San Jose, Taiwan and China offices, and was completed during the second quarter of 2009. All termination benefits recorded during 2009 were attributable to the plan initiated in December 2008.

In November 2006, we initiated a restructuring plan that included consolidation of our operations in order to reduce compensation and rent expense, while at the same time making critical infrastructure investments in people, processes and information systems to improve our operating efficiency. Although this plan was completed in the fourth quarter of 2008, lease termination expense was recorded in 2010 and 2009 due to decreases in estimated future sublease income and related professional fees.

**Interest and other income (loss), net**

Interest and other income (loss), net for the three and nine month periods ended September 30, 2010 and 2009, consisted of the following (in thousands):

	Three months ended September 30,			Nine months ended September 30,		
	2010	2009	\$ change	2010	2009	\$ change
Gain on sale of marketable securities	\$ 316	\$	\$ 316	\$ 660	\$	\$ 660
Interest expense <sup>1</sup>	(125)	(124)	(1)	(372)	(520)	148
Interest income <sup>2</sup>	17	53	(36)	49	226	(177)
Amortization of debt issuance costs <sup>3</sup>	(19)	(19)		(55)	(106)	51
Gain on repurchase of long-term debt, net <sup>4</sup>					12,860	(12,860)
Total interest and other income (loss), net	\$ 189	\$ (90)	\$ 279	\$ 282	\$ 12,460	\$ (12,178)

<sup>1</sup> Interest expense primarily relates to interest payable on our convertible subordinated debentures (the debentures). The decrease in the first nine months of 2010 compared to the first nine months of 2009 is due to the reduced outstanding principal balance which resulted from our repurchases of our debentures during the first half of 2009.

<sup>2</sup> Interest income is earned on cash equivalents and short-term marketable securities. The decrease in the third quarter of 2010 compared to the third quarter of 2009 is primarily due to decreased yields on balances of marketable securities. The decrease in the first nine months of 2010 compared to the first nine months of 2009 is primarily due to lower balances of marketable securities which resulted from our repurchases of our debentures during the first half of 2009 as well as decreased yields.

<sup>3</sup> The fees associated with the 2004 issuance of our debentures have been capitalized and are being amortized over a period of seven years. The decrease in the first nine months of 2010 compared to the first nine months of 2009 is due to the write-off of fees associated with the portions of our debentures repurchased in the first half of 2009. The remaining amortization period is less than one year as of September 30, 2010.

<sup>4</sup> In the first half of 2009, we repurchased and retired \$44.9 million principal amount of the debentures for \$31.5 million in cash. We recognized a net gain on the repurchase of \$12.9 million, which includes a \$13.4 million discount, offset by a write-off of debt issuance costs of \$0.5 million.



**Table of Contents****Provision (benefit) for income taxes**

The benefit for income taxes recorded for the third quarter of 2010 was primarily due to a benefit of \$0.7 million for the reversal of previously recorded tax contingencies due to the expiration of applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. The provision for income taxes recorded for the third quarter of 2009 included current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions.

The benefit for income taxes recorded for the first nine months of 2010 and 2009 of \$5.9 million and \$1.8 million, respectively, was primarily due to the reversal of previously recorded tax contingencies due to the expiration of the applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions.

**Business Outlook**

On October 21, 2010, we provided an outlook for the fourth quarter of 2010 in our earnings release, which was furnished on a current report on Form 8-K. The outlook provided the following anticipated financial results prepared in accordance with U.S. generally accepted accounting principles:

We expect to record the following in the fourth quarter of 2010:

Fourth quarter revenue of \$15 million to \$17 million.

Gross profit margin of approximately 46% to 50%.

Operating expenses of \$9.5 million to \$10.5 million.

**Liquidity and Capital Resources****Cash and short- and long-term marketable securities**

Our cash and cash equivalents and short- and long-term marketable securities as of September 30, 2010 and December 31, 2009, were as follows (dollars in thousands):

	September 30, 2010	December 31, 2009	\$ change	% change
Cash and cash equivalents	\$ 16,378	\$ 17,797	\$ (1,419)	(8)%
Short-term marketable securities	12,602	9,822	2,780	28
Long-term marketable securities	2,265	3,240	(975)	(30)
Total cash and marketable securities	\$ 31,245	\$ 30,859	\$ 386	1%

Total cash and marketable securities increased 1% from December 31, 2009 to September 30, 2010. The net increase in the first nine months of 2010 resulted primarily from \$3.1 million generated by operating activities and \$0.4 million of realized and unrealized gains on marketable securities. These increases were partially offset by \$1.8 million in payments on property and equipment and other asset financing and \$1.2 million for purchases of property and equipment.

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As of September 30, 2010, cash equivalents and short-term marketable securities included \$13.9 million in money market funds, \$2.9 million in commercial paper, \$9.1 million in U.S. government agencies debt

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securities, and \$1.0 million in corporate debt securities. At September 30, 2010, we also held a \$2.3 million long-term strategic equity investment in a publicly traded corporation. All of our investments were denominated in U.S. dollars, and our portfolio did not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral.

Despite the difficult credit environment, the quality of our short-term investment portfolio remains high. Our investment policy requires that at least 25% of our portfolio matures within 90 days. Additionally, no maturities can extend beyond 24 months and concentrations with individual securities are limited. Investments must be rated at least A-1 / P-1 by Standard & Poor's / Moody's, and our investment policy is reviewed at least annually by our Audit Committee. As of September 30, 2010, all of the short-term investments in our portfolio have maturities on or before May 15, 2011, the date we expect the holders to require us to purchase all of our outstanding convertible subordinated debentures.

The valuations of our short-term marketable securities are affected by a variety of factors, including changes in interest rates and the actual or perceived financial stability of the issuer. However, due to the high quality of our investments and their short-term nature, there has not been, and we do not expect there to be, a significant fluctuation in the valuation of these investments. Accordingly, we do not expect a materially negative impact on our financial condition from fluctuations in the value of our short-term investments. As of September 30, 2010, we had nominal unrealized gains and losses on these investments.

The valuation of our long-term equity investment has fluctuated significantly, and could continue to fluctuate significantly, due to a variety of factors including changes in the global economy and changes in the actual or expected performance of the issuing company. We have recorded other-than-temporary impairments related to this investment of \$7.9 million. Although the valuation of our investment has increased since we recorded our last other-than-temporary impairment in December 2008, we may record additional impairment charges in the future if we determine that any declines in value are other-than-temporary. Such an impairment would negatively impact our results of operations, but would not materially impact our financial condition.

We anticipate that our existing cash and investment balances will be adequate to fund our operating, investing and financing needs for the next twelve months. From time to time, we may evaluate acquisitions of businesses, products or technologies that complement our business. We may also repurchase additional amounts of our debentures and common stock. Any further transactions, if consummated, may consume a material portion of our working capital or require the issuance of equity securities that may result in dilution to existing shareholders.

### Accounts receivable, net

Accounts receivable, net decreased to \$5.3 million as of September 30, 2010 from \$5.6 million as of December 31, 2009. The average number of days sales outstanding increased to 27 days as of September 30, 2010 from 26 days as of December 31, 2009. The increase in days sales outstanding was due to normal fluctuations in the timing of sales and customer receipts within the third quarter of 2010.

### Inventories, net

Inventories, net decreased to \$5.5 million as of September 30, 2010 from \$6.2 million as of December 31, 2009 as a result of tightened inventory management. Inventory turnover on an annualized basis is 7.0 as of September 30, 2010 and December 31, 2009.

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### **Capital resources**

In 2004, we issued \$150.0 million of 1.75% convertible subordinated debentures (the debentures) due 2024. In 2006, we repurchased and retired \$10.0 million principal amount of the debentures and in 2008 we repurchased and retired \$79.4 million principal amount of the debentures. In 2009, we repurchased and retired \$44.9 million principal amount of the debentures for \$31.5 million in cash, reducing the balance of our outstanding debentures to \$15.8 million.

We may redeem some or all of the outstanding debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the debentures outstanding at each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019, at a purchase price equal to 100% of the principal amount plus accrued and unpaid interest. As of September 30, 2010 the debentures are classified as current liabilities as we expect the holders to require us to purchase all of the debentures on May 15, 2011. We intend to refinance or repurchase the debentures over the next twelve months or when due. The debentures are unsecured obligations and are subordinated in right of payment to all of our existing and future senior debt.

In September 2007, the Board of Directors authorized the repurchase of up to \$10.0 million of the Company's common stock under a share repurchase program that expired in September 2009. We repurchased 228,600 shares for approximately \$0.2 million in the first quarter of 2009 and no shares were repurchased during the remainder of 2009. Total cumulative repurchases under the plan were \$7.1 million.

### **Contractual Payment Obligations**

Our contractual obligations for 2010 and beyond are included in our Annual Report on Form 10-K for the year ended December 31, 2009, filed with the Securities and Exchange Commission (SEC) on March 10, 2010. Our obligations for 2010 and beyond have not changed materially as of September 30, 2010 except as disclosed under legal proceedings in Note 12: Commitments and Contingencies in the Notes to Condensed Consolidated Financial Statements of this Form 10-Q.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Interest rate fluctuations impact the interest income that we earn on our investment portfolio and the value of our investments. Factors that could cause interest rates to fluctuate include volatility in the credit and equity markets, such as the current uncertainty in global economic conditions; changes in the monetary policies of the United States and other countries and inflation. We mitigate risks associated with such fluctuations, as well as the risk of loss of principal, by investing in high-credit quality securities and limiting concentrations of issuers and maturity dates. Derivative financial instruments are not part of our investment portfolio.

During the first nine months of 2010 and as of September 30, 2010, a significant majority of our financial assets were held as cash equivalents or high quality short-term marketable securities with yields approaching zero. Accordingly, a hypothetical decrease in interest rates would not have a significant impact on our results of operations or financial position.

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As of September 30, 2010, we had convertible subordinated debentures of \$15.8 million outstanding with a fixed interest rate of 1.75%. Interest rate changes affect the fair value of the debentures, but do not affect our earnings or cash flow.

All of our sales and inventory purchases are denominated in U.S. dollars and, as a result, we have relatively little exposure to foreign currency exchange risk with respect to our sales or cost of goods sold. We have employees located in offices in Japan, Taiwan, Korea and the People's Republic of China and as such, a portion of our operating expenses as well as foreign income taxes payable are denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. We cannot reasonably estimate the effect that an immediate change in foreign currency exchange rates would have on our operating results or cash flows. Currently, we do not hedge against foreign currency rate fluctuations.

### **Item 4. Controls and Procedures. Evaluation of Disclosure Controls and Procedures**

Based on management's evaluation (with the participation of our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO )), as of the end of the period covered by this report, our CEO and CFO have concluded that 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, (the Exchange Act )) are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

### **Changes in Internal Control over Financial Reporting**

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **Inherent Limitations on Effectiveness of Controls**

Our management, including the CEO and CFO, does not expect that our Disclosure Controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been detected. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any system will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of the effectiveness of controls to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.



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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

For a discussion of legal proceedings, see Note 12: Commitments and Contingencies in the Notes to Condensed Consolidated Financial Statements of this Form 10-Q.

**Item 1A. Risk Factors.**

*Investing in our shares of common stock involves a high degree of risk, and investors should carefully consider the risks described below before making an investment decision. If any of the following risks occur, the market price of our shares of common stock could decline and investors could lose all or part of their investment. Additional risks that we currently believe are immaterial may also impair our business operations. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2009, including our consolidated financial statements and related notes, and our other filings made from time to time with the Securities and Exchange Commission.*

**Company Specific Risks**

*Dependence on a limited number of sole-source, third-party manufacturers for our products exposes us to shortages based on low manufacturing yield, errors in manufacturing, uncontrollable lead-times for manufacturing, capacity allocation, price increases with little notice, volatile inventory levels and delays in product delivery, which could result in delays in satisfying customer demand, increased costs and loss of revenue.*

We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. We rely on three third-party foundries to produce all of our wafers and three assembly and test vendors for completion of finished products. The wafers used in any one of our products are fabricated by only one foundry. Sole sourcing each product increases our dependence on our suppliers.

We have limited control over delivery schedules, quality assurance, manufacturing yields, potential errors in manufacturing and production costs. We do not have long-term supply contracts with our third-party manufacturers, so they are not obligated to supply us with products for any specific period of time, quantity or price, except as may be provided in a particular purchase order. Our suppliers can increase the prices of the products we purchase from them with little notice, which may cause us to increase the prices to our customers and harm our competitiveness. Because our requirements represent only a small portion of the total production capacity of our contract manufacturers, they are more likely to reallocate capacity to other customers even during periods of high demand for our products, as they have done in the past. We expect this may occur again in the future.

Establishing a relationship with a new contract manufacturer in the event of delays or increased prices would be costly and burdensome. The lead time to make such a change would be at least nine months, and the estimated time for us to adapt a product's design to a particular contract manufacturer's process is at least four months. If we have to qualify a new foundry or packaging, assembly and testing supplier for any of our products or if we are unable to obtain our products from our contract manufacturers on schedule, or at all, we could incur significant delays in shipping products, our ability to satisfy customer demand could be harmed, our revenue from the sale of products may be lost or delayed and our customer relationships and ability to obtain future design wins could be damaged.

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***Our product strategy, which is targeted at markets demanding superior video and image quality, may not lead to new design wins or significantly increased revenue in a timely manner or at all, which could materially adversely affect our results of operations and limit our ability to grow.***

We have adopted a product strategy that focuses on our core competencies in pixel processing and delivering high levels of video and image quality. With this strategy, we continue to make further investments in the development of our ImageProcessor architecture for the digital projector market, with particular focus on adding increased performance and functionality. For the advanced television market, we have shifted away from our previous approach of implementing our intellectual property ( IP ) exclusively in system-on-chip integrated circuits ( ICs ), to an approach designed to improve video performance of our customers' image processors through the use of our Motion Estimation Motion Compensation ( MEMC ) co-processor ICs. This strategy is designed to address the needs of the large-screen, high-resolution, high-quality segment of the television market. Although our new product strategy is developed to take advantage of market trends, such markets may not develop or may take longer to develop than we expect. We cannot assure you that the products we are developing will adequately address the demands of our target customers, or that we will be able to produce our new products at costs that enable us to price these products competitively.

Even if our product strategy is properly targeted, we cannot assure you that the products we are developing will lead to a significant increase in revenue from new design wins. To achieve design wins, we must design and deliver cost-effective, innovative and integrated semiconductors that overcome the significant costs associated with qualifying a new supplier and which make developers reluctant to change component sources. Additionally, potential developers may be less likely or unwilling to select our products due to concerns over our perceived financial stability. Further, design wins do not necessarily result in developers ordering large volumes of our products. Developers can choose at any time to discontinue using our products in their designs or product development efforts. A design win is not a binding commitment by a developer to purchase our products, but rather a decision by a developer to use our products in its design process. Even if our products are chosen to be incorporated into a developer's products, we may still not realize significant revenue from the developer if its products are not commercially successful or it chooses to qualify, or incorporate the products, of a second source.

***We have incurred indebtedness as a result of the sale of convertible debentures. We anticipate that we must repay or refinance the debentures by May 2011. We may be unable to meet this, or other, future capital requirements.***

As of September 30, 2010, \$15.8 million of our 1.75% convertible subordinated debentures (the debentures ) were outstanding. Although the debentures are not due until 2024, the holders have the right to require us to purchase all or a portion of the debentures at each of the following dates: May 15, 2011, May 15, 2014 and May 15, 2019. Since the market price of our common stock is significantly below the conversion price of the debentures, we expect the holders to exercise their put option on May 15, 2011. We may not be able to refinance the debentures at terms that are as favorable as those currently contained in the debentures, or at terms that are acceptable to us at all. While we believe that our current cash and marketable securities balances will be sufficient to meet our capital requirements for the next twelve months, we cannot assure you that we will be able to maintain sufficient cash and marketable security balances to refinance or pay off the debentures when and if the put option is exercised, or that such a repurchase would not result in cash reserves too low for us to continue our business as a going concern. We may need, or could elect to seek, additional funding through public or private equity or debt financing, which we may not be able to obtain. If we issue equity securities, our shareholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of our common stock.

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*We may fail to retain or attract the specialized technical and management personnel required to successfully operate our business.*

Our success depends on the continued services of our executive officers and other key management, engineering, and sales and marketing personnel and on our ability to continue to attract, retain and motivate qualified personnel. Competition for skilled engineers and management personnel is intense within our industry, and we may not be successful in hiring and retaining qualified individuals. The loss of, or inability to hire, key personnel could limit our ability to develop new products and adapt existing products to our customers' requirements, and may result in lost sales and a diversion of management resources. In the past three years we have experienced turn-over in several of our executive management positions and we have also experienced, and may continue to experience difficulty in hiring and retaining qualified engineering personnel in our Shanghai design center.

*We may be unable to successfully manage any future growth, including the integration of any future acquisition or equity investment, which could disrupt our business and severely harm our financial condition.*

We may determine that it is beneficial to increase our capacity to develop new and enhanced products in the future. If we fail to effectively manage internal growth, our operating expenses may increase more rapidly than our revenue, adversely affecting our financial condition and results of operations. To manage any future growth effectively in a rapidly evolving market, we must be able to maintain and improve our operational and financial systems, train and manage our employee base and attract and retain qualified personnel with relevant experience. We must also manage multiple relationships with customers, business partners, contract manufacturers, suppliers and other third parties. We could spend substantial amounts of time and money in connection with expansion efforts for which we may not realize any profit. Our systems, procedures or controls may not be adequate to support our operations and we may not be able to grow quickly enough to exploit potential market opportunities.

In addition, we may not be able to successfully integrate the businesses, products, technologies or personnel of any entity that we might acquire in the future, and any failure to do so could disrupt our business and seriously harm our financial condition. Our operation of any acquired business would involve numerous risks, including, but not limited to:

problems combining the acquired operations, technologies or products;

unanticipated costs;

diversion of management's attention from existing operations;

adverse effects on existing business relationships with customers;

risks associated with entering markets in which we have no or limited prior experience;

potential loss of key employees, particularly those of the acquired organizations; and

risks associated with implementing adequate internal control, management, financial and operating reporting systems.

Any future acquisitions and investments could also result in any of the following negative events, among others:

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issuance of stock that dilutes current shareholders' percentage ownership;

incurrence of debt;

assumption of liabilities;

amortization expenses related to acquired intangible assets;

impairment of goodwill;

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large and immediate write-offs; and

decreases in cash and marketable securities that could otherwise serve as working capital.

***Because of our long product development process and sales cycles, we may incur substantial costs before we earn associated revenue and ultimately may not sell as many units of our products as we originally anticipated.***

We develop products based on anticipated market and customer requirements and incur substantial product development expenditures, which can include the payment of large up-front, third-party license fees and royalties, prior to generating associated revenue. Our work under these projects is technically challenging and places considerable demands on our limited resources, particularly on our most senior engineering talent. Because the development of our products incorporates not only our complex and evolving technology but also our customers' specific requirements, a lengthy sales process is often required before potential customers begin the technical evaluation of our products. Our customers typically perform numerous tests and extensively evaluate our products before incorporating them into their systems. The time required for testing, evaluation and design of our products into a customer's system can take up to nine months or more. It can take an additional nine months or longer before a customer commences volume shipments of systems that incorporate our products. We cannot assure you that the time required for the testing, evaluation and design of our products by our customers would not be significantly longer than nine months.

Because of the lengthy development and sales cycles, we will experience delays between the time we incur expenditures for research and development, sales and marketing and inventory and the time we generate revenue, if any, from these expenditures. Additionally, if actual sales volumes for a particular product are substantially less than originally anticipated, we may experience large write-offs of capitalized license fees, software development tools, product masks, inventories or other capitalized or deferred product-related costs, or increased amortization of non-cancelable prepaid royalties, any of which would negatively affect our operating results. For example, inventory charges were \$1.2 million and \$1.5 million in 2009 and 2008, respectively and \$1.2 million for the nine months ended September 30, 2010.

***If we are not profitable in the future, we may be unable to continue our operations.***

Excluding gains on the repurchase of our convertible subordinated debentures, 2004 is our only year of profitability since inception and we have incurred operating losses since 2004. If and when we achieve profitability depends upon a number of factors, including our ability to develop and market innovative products, accurately estimate inventory needs, contract effectively for manufacturing capacity and maintain sufficient funds to finance our activities. If we are not profitable in the future, we may be unable to continue our operations.

***A significant amount of our revenue comes from a limited number of customers and distributors, exposing us to increased credit risk and subjecting our cash flow to the risk that any of our customers or distributors could decrease or cancel its orders.***

The display manufacturing market is highly concentrated and we are, and will continue to be, dependent on a limited number of customers and distributors for a substantial portion of our revenue. Sales to our top distributor represented 42%, 35% and 32% of revenue for the nine month period ended September 30, 2010 and years ended December 31, 2009 and 2008, respectively. Revenue attributable to our top five end customers represented 58%, 56% and 55% of revenue for the nine month period ended September 30, 2010 and the years ended December 31, 2009 and 2008, respectively. As of September 30, 2010 and 2009, we had three accounts that each represented 10% or more of accounts receivable. A reduction, delay or cancellation of orders from one or more of our significant customers, or a decision by one or more of our significant customers to select products manufactured by a competitor or to use its own

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internally-developed semiconductors, would significantly impact our revenue. Further, the concentration of our accounts receivable with a limited number of customers increases our credit risk. The failure of these customers to pay their balances, or any customer to pay future outstanding balances, would result in an operating expense and reduce our cash flows.

***Our dependence on selling to distributors and integrators increases the complexity of managing our supply chain and may result in excess inventory or inventory shortages.***

Selling to distributors and original equipment manufacturers ( OEMs ) that build display devices based on specifications provided by branded suppliers, also referred to as integrators, reduces our ability to forecast sales accurately and increases the complexity of our business. Our sales are made on the basis of customer purchase orders rather than long-term purchase commitments. Our distributors, integrators and customers may cancel or defer purchase orders at any time but we must order wafer inventory from our contract manufacturers three to four months in advance.

The estimates we use for our advance orders from contract manufacturers are based, in part, on reports of inventory levels and production forecasts from our distributors and integrators, which act as intermediaries between us and the companies using our products. This process requires us to make numerous assumptions concerning demand and to rely on the accuracy of the reports and forecasts of our distributors and integrators, each of which may introduce error into our estimates of inventory requirements. Our failure to manage this challenge could result in excess inventory or inventory shortages that could materially impact our operating results or limit the ability of companies using our semiconductors to deliver their products. For example, we overestimated demand for certain of our products which led to significant charges for obsolete inventory in 2009 and 2008. On the other hand, if we underestimate demand, we would forego revenue opportunities, lose market share and damage our customer relationships.

***International sales account for almost all of our revenue, and if we do not successfully address the risks associated with international sales, our revenue could decrease.***

Sales outside the U.S. accounted for approximately 96%, 97% and 95% of revenue for the nine month period ended September 30, 2010 and the years ended December 31, 2009 and 2008, respectively. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenue in future periods. In addition, customers who incorporate our products into their products sell a substantial portion of their products outside of the U.S., and all of our products are manufactured outside of the U.S. We are, therefore, subject to many international risks, including, but not limited to:

increased difficulties in managing international distributors and manufacturers due to varying time zones, languages and business customs;

foreign currency exchange fluctuations in the currencies of Japan, the People's Republic of China ( PRC ), Taiwan or Korea;

reduced or limited protection of our IP, particularly in software, which is more prone to design piracy;

difficulties in collecting outstanding accounts receivable balances;

potentially adverse tax consequences;

difficulties regarding timing and availability of export and import licenses;

political and economic instability, particularly in the PRC, Japan, Taiwan, or Korea;

difficulties in maintaining sales representatives outside of the U.S. that are knowledgeable about our industry and products;

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changes in the regulatory environment in the PRC, Japan, Taiwan and Korea that may significantly impact purchases of our products by our customers; and

outbreaks of health epidemics in the PRC or other parts of Asia.

***The concentration of our manufacturers and customers in the PRC, Japan, Korea and Taiwan increases our risk that a natural disaster, work stoppage or economic or political instability in the region could disrupt our operations.***

Most of our current manufacturers and customers are located in the PRC, Japan, Korea or Taiwan. In addition, a majority of our employees are located in this region. Disruptions from natural disasters, health epidemics and political, social and economic instability may affect the region and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation, foreign currency flows and balance of payments position, among others. We cannot be assured that the PRC's economic policies will be consistent or effective. Our results of operations and financial position may be harmed by changes in the PRC's political, economic or social conditions.

In addition, the risk of earthquakes in the Pacific Rim region is significant due to the proximity of major earthquake fault lines in the area. Common consequences of earthquakes include power outages and disruption or impairment of production capacity. Earthquakes, fire, flooding, power outages and other natural disasters in the Pacific Rim region, or political unrest, labor strikes or work stoppages in countries where our manufacturers and customers are located, would likely result in the disruption of our manufacturers' and customers' operations. Any disruption resulting from extraordinary events could cause significant delays in shipments of our products until we are able to shift our manufacturing from the affected contractor to another third-party vendor. There can be no assurance that alternative capacity could be obtained on favorable terms, or in a timely manner, if at all.

***We may be unable to successfully implement new products or enhancements to our current products due to our prior or any potential future restructuring actions, which could adversely affect our future sales and financial condition.***

We initiated restructuring plans in November 2006 and December 2008 which were completed in December 2008 and June 2009, respectively. These restructuring plans included consolidation and closure of certain offices, reductions in headcount and significant write-offs of assets. Although our restructuring plans were intended to improve efficiency and return the Company to profitability, these restructuring plans and any future restructuring actions may slow our development of new or enhanced products by limiting our research and development and engineering activities. If we are unable to successfully introduce new or enhanced products, our sales and financial condition will be adversely affected.

***Continued compliance with regulatory and accounting requirements will be challenging and will require significant resources.***

We spend a significant amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including evolving Securities and Exchange Commission rules and regulations, NASDAQ Global Market rules, the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires management's annual review and evaluation of internal control over financial reporting. If we are unable to maintain an effective system of internal controls, our shareholders could lose confidence in the accuracy and completeness of our financial reports which in turn could cause our stock price to decline.

Additionally, one of the covenants of the indenture governing the debentures could possibly be interpreted such that if we are late with any of our required filings under the Securities Exchange Act of



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1934, as amended ( Exchange Act ), and if we fail to affect a cure within 60 days, the holders of the debentures can put the debentures back to the Company, whereby the debentures become immediately due and payable. As a result of our restructuring efforts, we have fewer employees to perform day-to-day controls, processes and activities and, additionally, certain functions have been transferred to new employees who are not as familiar with our procedures. These changes increase the risk that we will be unable to make timely filings in accordance with the Exchange Act. Any resulting default under our debentures would have a material adverse effect on our cash position and operating results.

***Our effective income tax rate is subject to unanticipated changes in, or different interpretations of tax rules and regulations and forecasting our effective income tax rate is complex and subject to uncertainty.***

As a global company, we are subject to taxation by a number of taxing authorities and as such, our tax rates vary among the jurisdictions in which we operate. Unanticipated change in our tax rates could affect our future results of operations. Our effective tax rates could be adversely affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in tax laws or the interpretation of tax laws either in the United States or abroad, or by changes in the valuation of our deferred tax assets and liabilities. The ultimate outcomes of any future tax audits are uncertain, and we can give no assurance as to whether an adverse result from one or more of them would have a material effect on our operating results and financial position.

The computation of income tax expense is complex as it is based on the laws of numerous tax jurisdictions and requires significant judgment on the application of complicated rules governing accounting for tax provisions under U.S. generally accepted accounting principles. Income tax expense for interim quarters is based on a forecast of our global tax rate for the year, which includes forward looking financial projections, including the expectations of profit and loss by jurisdiction, and contains numerous assumptions. For these reasons, our global tax rate may be materially different than our forecast.

## **Company Risks Related to the Semiconductor Industry and Our Markets**

***Our highly integrated products and high-speed mixed signal products are difficult to manufacture without defects and the existence of defects could result in increased costs, delays in the availability of our products, reduced sales of products or claims against us.***

The manufacture of semiconductors is a complex process and it is often difficult for semiconductor foundries to produce semiconductors free of defects. Because many of our products are more highly integrated than other semiconductors and incorporate mixed signal analog and digital signal processing, multi-chip modules and embedded memory technology, they are even more difficult to produce without defects. Defective products can be caused by design or manufacturing difficulties. Therefore, identifying quality problems can occur only by analyzing and testing our semiconductors in a system after they have been manufactured. The difficulty in identifying defects is compounded because the process technology is unique to each of the multiple semiconductor foundries we contract with to manufacture our products. Despite testing by both our customers and us, errors or performance problems may be found in existing or new semiconductors.

Failure to achieve defect-free products may result in increased costs and delays in the availability of our products. Additionally, customers could seek damages from us for their losses and shipments of defective products may harm our reputation with our customers. We have experienced field failures of our semiconductors in certain customer applications that required us to institute additional testing. As a result of these field failures, we have incurred warranty costs due to customers returning potentially affected products and have experienced reductions in revenues due to delays in production. Our customers have also experienced delays in receiving product shipments from us that resulted in the loss of revenue and

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profits. Shipments of defective products could cause us to lose customers or to incur significant replacement costs, either of which would harm our business.

***The development of new products is extremely complex and we may be unable to develop our new products in a timely manner and without defects, errors or bugs, or at all, which would result in a failure to obtain new design wins and/or maintain our current revenue levels.***

The development of semiconductors is a complex and time-consuming process and many of our products are highly integrated and incorporate mixed analog and digital signal processing, multichip modules and embedded memory technology, further complicating the development process. In addition to the inherent difficulty of designing complex ICs, product development delays may result from:

difficulties in hiring and retaining necessary technical personnel;

difficulties with contract manufacturers;

difficulties in reallocating engineering resources and overcoming resource limitations;

changes to product specifications and customer requirements;

changes to market or competitive product requirements; and

unanticipated engineering complexities.

Even if we are able to meet our customers' design windows, the highly complex products we provide to our customers may contain defects, errors and bugs when they are first introduced. We have in the past and may in the future experience these defects, errors and bugs. In addition, if any of our products do contain defects, errors or bugs when first introduced, we may be unable to correct the problems. Consequently, our reputation may be damaged and customers may be reluctant to buy our products, which could harm our ability to retain existing customers and to attract new customers. In addition, any defects, errors or bugs could interrupt or delay sales of our new products to our customers. If we are not successful in development of new products, our financial results will be adversely affected.

***We use a customer owned tooling process for manufacturing most of our products which exposes us to the possibility of poor yields and unacceptably high product costs.***

We build most of our products on a customer owned tooling basis, also known in the semiconductor industry as COT, whereby we directly contract the manufacture of our products, including wafer production, assembly and test. As a result, we are subject to increased risks arising from wafer manufacturing yields and risks associated with coordination of the manufacturing, assembly and testing process. Poor product yields result in higher product costs, which could make our products less competitive if we increase our prices to compensate for our higher costs, or could result in lower gross profit margins if we do not increase our prices.

***Intense competition in our markets may reduce sales of our products, reduce our market share, decrease our gross profit and result in large losses.***

We compete with specialized and diversified electronics and semiconductor companies that offer display processors or scaling components. Some of these include Broadcom Corporation, i-Chips Technologies Inc., Integrated Device Technology, Inc., Intersil Corporation, MediaTek Inc., MStar Semiconductor, Inc., Realtek Semiconductor Corp., Renesas Electronics America., Sigma Designs, Inc., Silicon Image, Inc., STMicroelectronics N.V., Sunplus Technology Co., Ltd., Trident Microsystems, Inc., Zoran Corporation and other companies. Potential and current competitors may include diversified semiconductor manufacturers and the semiconductor divisions or affiliates of some of our customers, including Intel Corporation, LG Electronics, Inc., Matsushita Electric Industrial Co., Ltd., Mitsubishi Digital Electronics America, Inc., NEC Corporation, NVIDIA Corporation, Samsung Electronics Co., Ltd., SANYO Electric Co., Ltd., Seiko Epson Corporation, Sharp

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Electronics Corporation, Sony Corporation, Texas Instruments Incorporated and Toshiba America, Inc. In addition, start-up companies may seek to compete in our markets.

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Many of our competitors have longer operating histories and greater resources to support development and marketing efforts than we do. Some of our competitors operate their own fabrication facilities. These competitors may be able to react more quickly and devote more resources to efforts that compete directly with our own. Our current or potential customers have developed, and may continue to develop, their own proprietary technologies and become our competitors. Increased competition from both competitors and our customers' internal development efforts could harm our business, financial condition and results of operations by, for example, increasing pressure on our profit margin or causing us to lose sales opportunities. We cannot assure you that we can compete successfully against current or potential competitors.

***If we are not able to respond to the rapid technological changes and evolving industry standards in the markets in which we compete, or seek to compete, our products may become less desirable or obsolete.***

The markets in which we compete or seek to compete are subject to rapid technological change and miniaturization capabilities, frequent new product introductions, changing customer requirements for new products and features and evolving industry standards. The introduction of new technologies and emergence of new industry standards could render our products less desirable or obsolete, which could harm our business and significantly decrease our revenue. Examples of changing industry standards include the growing use of broadband to deliver video content, increased display resolution and size, faster screen refresh rates, video capability such as high definition and 3D, the proliferation of new display devices and the drive to network display devices together. Our products are incorporated into our customers' products, which have different parts and specifications and utilize multiple protocols that allow them to be compatible with specific computers, video standards and other devices. If our customers' products are not compatible with these protocols and standards, consumers will return, or not purchase, these products and the markets for our customers' products could be significantly reduced. As a result, a portion of our market would be eliminated, and our business would be harmed.

***Our developed software may be incompatible with industry standards and challenging and costly to implement, which could slow product development or cause us to lose customers and design wins.***

We provide our customers with software development tools and with software that provides basic functionality for our ICs and enables enhanced connectivity of our customers' products. Software development is a complex process and we are dependent on software development languages and operating systems from vendors that may limit our ability to design software in a timely manner. Also, as software tools and interfaces change rapidly, new software languages introduced to the market may be incompatible with our existing systems and tools, requiring significant engineering efforts to migrate our existing systems in order to be compatible with those new languages. Software development disruptions could slow our product development or cause us to lose customers and design wins. The integration of software with our products adds complexity, may extend our internal development programs and could impact our customers' development schedules. This complexity requires increased coordination between hardware and software development schedules and increases our operating expenses without a corresponding increase in product revenue. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

***The competitiveness and viability of our products could be harmed if necessary licenses of third-party technology are not available to us or are only available on terms that are not commercially viable.***

We license technology from independent third parties that is incorporated into our products or product enhancements. Future products or product enhancements may require additional third-party licenses that may not be available to us or may not be available on terms that are commercially reasonable. In addition, in the event of a change in control of one of our licensors, it may become difficult to maintain access to its

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licensed technology. If we are unable to obtain or maintain any third-party license required to develop new products and product enhancements, we may have to obtain substitute technology with lower quality or performance standards, or at greater cost, either of which could seriously harm the competitiveness of our products.

See Note 12: Commitments and Contingencies in the Notes to Condensed Consolidated Financial Statements of this Form 10-Q for additional information on current litigation related to licensed technology.

***Our limited ability to protect our IP and proprietary rights could harm our competitive position by allowing our competitors to access our proprietary technology and to introduce similar products.***

Our ability to compete effectively with other companies will depend, in part, on our ability to maintain the proprietary nature of our technology, including our semiconductor designs and software code. We provide the computer programming code for our software to customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to help protect our proprietary technologies. As of September 30, 2010 we held 130 patents and had 28 patent applications pending for protection of our significant technologies. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources than we do, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or they may develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries.

We cannot assure you that the degree of protection offered by patent or trade secret laws will be sufficient. Furthermore, we cannot assure you that any patents will be issued as a result of any pending applications or that any claims allowed under issued patents will be sufficiently broad to protect our technology. In addition, it is possible that existing or future patents may be challenged, invalidated or circumvented.

***Others may bring infringement actions against us that could be time consuming and expensive to defend.***

We may become subject to claims involving patents or other IP rights. IP claims could subject us to significant liability for damages and invalidate our proprietary rights. In addition, IP claims may be brought against customers that incorporate our products in the design of their own products. These claims, regardless of their success or merit and regardless of whether we are named as defendants in a lawsuit, would likely be time consuming and expensive to resolve and would divert the time and attention of management and technical personnel. Any IP litigation or claims also could force us to do one or more of the following:

stop selling products using technology that contains the allegedly infringing IP;

attempt to obtain a license to the relevant IP, which may not be available on reasonable terms or at all;

attempt to redesign those products that contain the allegedly infringing IP; or

pay damages for past infringement claims that are determined to be valid or which are arrived at in settlement of such litigation or threatened litigation.

If we are forced to take any of the foregoing actions, we may incur significant additional costs or be unable to manufacture and sell our products, which could seriously harm our business. In addition, we may not be able to develop, license or acquire non-infringing technology under reasonable terms. These developments could result in an inability to compete for customers or otherwise adversely affect our results of operations.

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*We are dependent on manufacturers of our semiconductor products not only to respond to changes in technology and industry standards but also to continue the manufacturing processes on which we rely.*

To respond effectively to changes in technology and industry standards, we are dependent on our foundries to implement advanced semiconductor technologies and our operations could be adversely affected if those technologies are unavailable, delayed or inefficiently implemented. In order to increase performance and functionality and reduce the size of our products, we are continuously developing new products using advanced technologies that further miniaturize semiconductors and we are dependent on our foundries to develop and provide access to the advanced processes that enable such miniaturization. We cannot be certain that future advanced manufacturing processes will be implemented without difficulties, delays or increased expenses. Our business, financial condition and results of operations could be materially adversely affected if advanced manufacturing processes are unavailable to us, substantially delayed or inefficiently implemented.

Creating the capacity for new technological changes may cause manufacturers to discontinue older manufacturing processes in favor of newer ones. We must then either retire the affected part or develop a new version of the part that can be manufactured with a newer process. In the event that a manufacturing process is discontinued, our current suppliers may be unwilling or unable to manufacture our current products. We may not be able to place last time buy orders for the old technology or find alternate manufacturers of our products to allow us to continue to produce products with the older technology while we expend the significant costs for research and development and time to migrate to new, more advanced processes. For instance, we also utilize 0.18um and 0.15um standard logic processes, which may only be available for the next five to seven years. Additionally, a portion of our products use 0.11um technology for memory die, which is being phased out in favor of 65nm memory die to increase yields and decrease cost. Because of this transition, our customers must re-qualify the affected parts.

*Shortages of materials used in the manufacturing of our products and other key components of our customers' products may increase our costs, impair our ability to ship our products on time and delay our ability to sell our products.*

From time to time, shortages of components and materials that are critical to the manufacture of our products and our customers' products may occur. Such critical components and materials include semiconductor wafers and packages, double data rate memory die, display components, analog-to-digital converters, digital receivers, video decoders and voltage regulators. If material shortages occur, we may incur additional costs or be unable to ship our products to our customers in a timely fashion, both of which could harm our business and adversely affect our results of operations.

*Our products are characterized by average selling prices that decline over relatively short periods of time, which will negatively affect our financial results unless we are able to reduce our product costs or introduce new products with higher average selling prices.*

Average selling prices for our products decline over relatively short periods of time, while many of our product costs are fixed. When our average selling prices decline, our gross profit declines unless we are able to sell more units or reduce the cost to manufacture our products. We have experienced declines in our average selling prices and expect that we will continue to experience them in the future, although we cannot predict when they may occur or how severe they will be. Our financial results will suffer if we are unable to offset any reductions in our average selling prices by increasing our sales volumes, reducing our costs, adding new features to our existing products or developing new or enhanced products in a timely manner with higher selling prices or gross profits.

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*The cyclical nature of the semiconductor industry may lead to significant variances in the demand for our products and could harm our operations.*

In the past, the semiconductor industry has been characterized by significant downturns and wide fluctuations in supply and demand. Also, the industry has experienced significant fluctuations in anticipation of changes in general economic conditions, including economic conditions in Asia, Europe and North America. The cyclical nature of the semiconductor industry has also led to significant variances in product demand and production capacity. We have experienced, and may continue to experience, periodic fluctuations in our financial results because of changes in industry-wide conditions.

*Environmental laws and regulations have caused us to incur, and may again cause us to incur, significant expenditures to comply with applicable laws and regulations, and we may be assessed considerable penalties for noncompliance.*

We are subject to numerous environmental laws and regulations. Compliance with current or future environmental laws and regulations could require us to incur substantial expenses which could harm our business, financial condition and results of operations. We have worked, and will continue to work, with our suppliers and customers to ensure that our products are compliant with enacted laws and regulations. Failure by us or our contract manufacturers to comply with such legislation could result in customers refusing to purchase our products and could subject us to significant monetary penalties in connection with a violation, either of which would have a material adverse effect on our business, financial condition and results of operations. Current environmental laws and regulations could become more stringent over time, imposing even greater compliance costs and increasing risks and penalties associated with violations, which could seriously harm our business, financial condition and results of operations. There can be no assurance that violations of environmental laws or regulations will not occur in the future as a result of our inability to obtain permits, human error, equipment failure or other causes.

## **Other Risks**

*The current adverse global economic environment and volatility in global credit and financial markets could materially and adversely affect our business and results of operations.*

Slow economic activity, increased unemployment, decreased business and consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns have contributed to and continue to contribute to a challenging economic environment. This environment has led to reduced spending in the markets in which we compete and made it difficult for our customers, our vendors and us to accurately forecast and plan future business activities. Furthermore, the constraints in the capital and credit markets may limit the ability of our customers to meet their liquidity needs, which could result in an impairment of their ability to make timely payments to us and to reduce their demand for our products, adversely impacting our results of operations and cash flows.

*The price of our common stock has and may continue to fluctuate substantially.*

Our stock price and the stock prices of technology companies similar to Pixelworks have been highly volatile. The price of our common stock may decline and the value of your investment may be reduced regardless of our performance. Market fluctuations, as well as general economic and political conditions, including recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our common stock. Additional factors that could negatively impact our stock price include:

actual or anticipated fluctuations in our operating results;

changes in expectations as to our future financial performance;

changes in financial estimates of securities analysts;

announcements by us or our competitors of technological innovations, design wins, contracts, standards or acquisitions;



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the operating and stock price performance of other comparable companies;

inconsistent trading volume levels of our common stock; and

changes in market valuations of other technology companies.

Any inability or perceived inability of investors to realize a gain on an investment in our common stock could have an adverse effect on our business, financial condition and results of operations by potentially limiting our ability to retain our customers, to attract and retain qualified employees and to raise capital.

***We may be unable to maintain compliance with NASDAQ Marketplace Rules which could cause our common stock to be delisted from the NASDAQ Global Market. This could result in the lack of a market for our common stock, cause a decrease in the value of our common stock, and adversely affect our business, financial condition and results of operations.***

On June 4, 2008, we effected a one-for-three reverse split of our common stock. We effected the reverse split to regain compliance with NASDAQ Marketplace Rules, particularly the minimum \$1.00 per share requirement for continued inclusion on the NASDAQ Global Market. Though the per share price of our common stock was \$3.31 on October 29, 2010, the price has fluctuated significantly and was below \$1.00 as recently as May 6, 2009. We cannot guarantee that it will remain at or above \$1.00 per share and if the price again drops below \$1.00 per share, the stock could become subject to delisting again, and we may seek shareholder approval for an additional reverse split. A second reverse split could produce adverse effects and may not result in a long-term or permanent increase in the price of our common stock.

If our common stock is delisted, trading of the stock will most likely take place on an over-the-counter market established for unlisted securities. An investor is likely to find it less convenient to sell, or to obtain accurate quotations in seeking to buy, our common stock on an over-the-counter market, and many investors may not buy or sell our common stock due to difficulty in accessing over-the-counter markets, or due to policies preventing them from trading in securities not listed on a national exchange or other reasons. For these reasons and others, delisting would adversely affect the liquidity, trading volume and price of our common stock, causing the value of an investment in us to decrease and having an adverse effect on our business, financial condition and results of operations by limiting our ability to attract and retain qualified executives and employees and limiting our ability to raise capital.

***The anti-takeover provisions of Oregon law and in our articles of incorporation could adversely affect the rights of the holders of our common stock by preventing a sale or takeover of us at a price or prices favorable to the holders of our common stock.***

Provisions of our articles of incorporation and bylaws and provisions of Oregon law may have the effect of delaying or preventing a merger or acquisition of us, making a merger or acquisition of us less desirable to a potential acquirer or preventing a change in our management, even if our shareholders consider the merger, acquisition or change in management favorable or if doing so would benefit our shareholders. In addition, these provisions could limit the price that investors would be willing to pay in the future for shares of our common stock. The following are examples of such provisions in our articles of incorporation or bylaws:

our board of directors is authorized, without prior shareholder approval, to change the size of the board (our articles of incorporation provide that if the board is increased to eight or more members, the board will be divided into three classes serving staggered terms, which would make it more difficult for a group of shareholders to quickly change the composition of our board);

our board of directors is authorized, without prior shareholder approval, to create and issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us or to effect a change of control, commonly referred to as blank check preferred stock;

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members of our board of directors can be removed only for cause and at a meeting of shareholders called expressly for that purpose, by the vote of 75 percent of the votes then entitled to be cast for the election of directors; and

our board of directors may alter our bylaws without obtaining shareholder approval; and shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting.

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**Item 6. Exhibits.**

- 10.1 Summary of Pixelworks Non-Employee Director Compensation
- 10.2 Pixelworks, Inc. Amended and Restated 2006 Stock Incentive Plan, Terms and Conditions of Director Stock Unit Award
- 31.1 Certification of Chief Executive Officer.
- 31.2 Certification of Chief Financial Officer.
- 32.1\* Certification of Chief Executive Officer.
- 32.2\* Certification of Chief Financial Officer.

\* Exhibits 32.1 and 32.2 are being furnished and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act ), or otherwise subject to the liability of that section, nor shall such exhibits be deemed to be incorporated by reference in any registration statement or other document filed under the Securities Act of 1933, as amended, or the Exchange Act, except as otherwise stated in such filing.

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**SIGNATURE**

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.

Dated: November 4, 2010

PIXELWORKS, INC.

/s/ Steven L. Moore  
Steven L. Moore

*Vice President, Chief Financial*

*Officer, Secretary and Treasurer*