PIXELWORKS, INC
Form 10-Q
August 11, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008.

or

o **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	**91-1761992**
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)

8100 SW Nyberg Road
Tualatin, Oregon 97062
(503) 454-1750

(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 þ No o

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 o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting Company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Number of shares of Common Stock outstanding as of July 31, 2008: 14,526,127

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008
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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

PIXELWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 59,394	$ 74,572
Short-term marketable securities	14,804	34,581
Accounts receivable, net	6,738	6,223
Inventories, net	6,271	11,265
Prepaid expenses and other current assets	3,862	3,791
Total current assets	91,069	130,432
Long-term marketable securities	7,495	9,804
Property and equipment, net	5,747	6,148
Other assets, net	7,036	6,902
Debt issuance costs, net	1,237	2,260
Acquired intangible assets, net	4,796	6,370
Total assets	$ 117,380	$ 161,916
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,658	$ 3,992
Accrued liabilities and current portion of long-term liabilities	9,988	13,848
Current portion of income taxes payable	281	232
Total current liabilities	13,927	18,072
Long-term liabilities, net of current portion	1,719	1,236
Income taxes payable, net of current portion	10,524	10,635
Long-term debt	89,752	140,000
Total liabilities	115,922	169,943
Commitments and contingencies		
Shareholders equity (deficit):		
Preferred stock		
Common stock	334,386	333,934

Shares exchangeable into common stock		113
Accumulated other comprehensive loss	(515)	(4,778)
Accumulated deficit	(332,413)	(337,296)
Total shareholders equity (deficit)	1,458	(8,027)
Total liabilities and shareholders equity	$ 117,380	$ 161,916

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenue, net	$ 20,793	$ 26,896	$ 44,769	$ 50,877
Cost of revenue (1)	10,295	15,294	22,600	29,422
Gross profit	10,498	11,602	22,169	21,455
Operating expenses:				
Research and development (2)	7,193	9,675	13,915	21,650
Selling, general and administrative (3)	4,491	7,013	9,177	14,538
Restructuring	(158)	2,635	850	5,403
Amortization of acquired intangible assets	74	90	164	180
Total operating expenses	11,600	19,413	24,106	41,771
Loss from operations	(1,102)	(7,811)	(1,937)	(20,316)
Interest income	553	1,444	1,536	2,971
Other income	218		218	
Interest expense	(419)	(688)	(992)	(1,345)
Amortization of debt issuance costs	(125)	(166)	(271)	(331)
Gain on repurchase of long-term debt, net			11,557	
Other-than-temporary impairment of marketable security			(6,490)	
Interest and other income, net	227	590	5,558	1,295
Income (loss) before income taxes	(875)	(7,221)	3,621	(19,021)
Provision (benefit) for income taxes	375	399	(1,262)	1,021
Net income (loss)	$ (1,250)	$ (7,620)	$ 4,883	$ (20,042)
Net income (loss) per share basic and diluted	$ (0.09)	$ (0.47)	$ 0.33	$ (1.23)
Weighted averages shares outstanding:				
Basic	14,577	16,286	14,753	16,273
Diluted	14,577	16,286	14,766	16,273

(1) Includes:				
Amortization of acquired developed technology	$ 705	$ 705	$ 1,410	$ 1,410
Stock-based compensation	20	28	38	48
Restructuring		35		136
(2) Includes stock-based compensation	449	510	898	1,180
(3) Includes stock-based compensation	313	916	738	1,949

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities:		
Net income (loss)	$ 4,883	$ (20,042)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on repurchase of long-term debt, net	(11,557)	
Other-than-temporary impairment of marketable security	6,490	
Depreciation and amortization	3,375	7,742
Stock-based compensation	1,674	3,177
Amortization of acquired intangible assets	1,574	1,590
Deferred income tax benefit	(473)	
Accretion on short- and long-term marketable securities	(295)	(147)
Amortization of debt issuance costs	271	331
Loss on asset disposals	80	206
Write off of certain assets related to restructuring		572
Unrealized foreign currency gain on investments		(201)
Other	27	26
Changes in operating assets and liabilities:		
Accounts receivable, net	(515)	293
Inventories, net	4,994	(3,060)
Prepaid expenses and other current and long-term assets, net	(535)	974
Accounts payable	(334)	4,891
Accrued current and long-term liabilities	(1,667)	(1,202)
Income taxes payable	(62)	(463)
Net cash provided by (used in) operating activities	7,930	(5,313)
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	36,814	30,118
Purchases of marketable securities	(16,659)	(15,556)
Payments on asset financings	(2,764)	(3,609)
Purchases of property and equipment	(1,245)	(1,496)
Proceeds from sales of property and equipment	20	
Net cash provided by investing activities	16,166	9,457
Cash flows from financing activities:		
Repurchase of long-term debt	(37,939)	
Repurchase of common stock	(1,371)	
Proceeds from issuances of common stock	36	250

Net cash provided by (used in) financing activities	(39,274)	250
Net change in cash and cash equivalents	(15,178)	4,394
Cash and cash equivalents, beginning of period	74,572	63,095
Cash and cash equivalents, end of period	$ 59,394	$ 67,489

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. Our solutions enable manufacturers of digital display and projection devices, such as multimedia projectors and large-screen liquid crystal display (LCD) televisions to differentiate their products with a consistently high level of video quality.

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 six month periods ended June 30, 2008 and 2007 is unaudited; however, such information reflects all adjustments, consisting only 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, 2007 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2007, included in Item 8 of our Annual Report on Form 10-K, filed with the SEC on March 12, 2008, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three and six month periods ended June 30, 2008 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2008.

Use of Estimates

The preparation of consolidated financial statements in conformity with 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 valuation of short- and long-term marketable securities, product returns, warranty obligations, bad debts, inventories, property and equipment, intangible assets, valuation of share-based payments, income taxes, litigation and other contingencies. The actual results experienced could differ materially from our estimates.

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Reclassifications

Certain reclassifications have been made to the 2007 condensed consolidated financial statements to conform with the 2008 presentation.

NOTE 2: BALANCE SHEET COMPONENTS

Marketable Securities

As of June 30, 2008 and December 31, 2007, all of our short- and long-term marketable securities are available-for-sale.

Unrealized holding gains (losses) on short- and long-term available-for-sale securities, net of tax, were $25 and $(497), respectively, as of June 30, 2008 and $(22) and $(4,713), respectively, as of December 31, 2007. These unrealized holding gains and losses are recorded in accumulated other comprehensive loss, a component of shareholders equity (deficit), in the condensed consolidated balance sheets. We have determined that as of June 30, 2008, gross unrealized losses on our marketable securities were temporary based on our intent and ability to hold the investments until recovery.

Accounts Receivable, Net

Accounts receivable are recorded at invoiced amount and do not bear interest when recorded or accrue interest when past due. We do not have any off balance sheet exposure risk related to customers. 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, net consists of the following:

	June 30, 2008	December 31, 2007
Accounts receivable, gross	$ 7,280	$ 6,765
Less: allowance for doubtful accounts	(542)	(542)
Accounts receivable, net	$ 6,738	$ 6,223

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

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Balance at beginning of period	$ 542	$ 200
Provision		483
Recoveries		(41)
Balance at end of period	$ 542	$ 642

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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.

Inventories, net consists of the following:

	June 30, 2008	December 31, 2007
Finished goods	$ 6,559	$ 12,733
Work-in-process	5,238	4,482
	11,797	17,215
Less: reserve for slow-moving and obsolete items	(5,526)	(5,950)
Inventory, net	$ 6,271	$ 11,265

The following is the change in our reserve for slow-moving and obsolete items:

	Six Months Ended June 30,	
	2008	2007
Balance at beginning of period	$ 5,950	$ 5,950
Provision	1,315	2,008
Usage:		
Sales	(655)	(586)
Scrap	(1,084)	(1,545)
Total usage	(1,739)	(2,131)
Balance at end of period	$ 5,526	$ 5,827

Based upon our forecast and backlog, we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand at June 30, 2008. However, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. It is not possible for us to predict if or when this may happen, or how much we may sell. 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, net consists of the following:

	June 30, 2008	December 31, 2007
Gross carrying amount	$ 19,056	$ 17,109
Less: accumulated depreciation and amortization	(13,309)	(10,961)
Property and equipment, net	$ 5,747	$ 6,148

Acquired Intangible Assets, Net

Acquired intangible assets, net consists of the following:

	June 30, 2008	December 31, 2007
Gross carrying amount:		
Developed technology	$ 19,170	$ 19,170
Customer relationships	1,689	1,689
	20,859	20,859
Less accumulated amortization:		
Developed technology	(14,374)	(12,964)
Customer relationships	(1,689)	(1,525)
	(16,063)	(14,489)
Acquired intangible assets, net	$ 4,796	$ 6,370

Estimated future amortization of acquired developed technology is as follows:

Six Months Ending December 31:	
2008	$ 1,410
Year Ending December 31:	
2009	2,336
2010	1,050
	$ 4,796

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	June 30, 2008	December 31, 2007
Accrued payroll and related liabilities	$ 3,416	$ 3,366
Current portion of accrued liabilities for asset financings	2,290	4,150
Accrued costs related to restructuring	1,014	2,918
Reserve for warranty returns	726	932
Accrued interest payable	295	405
Accrued commissions and royalties	235	381
Reserve for sales returns and allowances	175	175
Other	1,837	1,521
	$ 9,988	$ 13,848

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

	Six Months Ended June 30,	
	2008	2007
Reserve for warranty returns:		
Balance at beginning of period	$ 932	$ 662
Provision	(54)	682
Charge offs	(152)	(502)
Balance at end of period	$ 726	$ 842
Reserve for sales returns and allowances:		
Balance at beginning of period	$ 175	$ 479
Provision	14	18
Charge offs	(14)	(322)
Balance at end of period	$ 175	$ 175

Long-Term Debt

In 2004, we issued $150,000 of 1.75% convertible subordinated debentures (the debentures) due 2024. In February 2006, we repurchased and retired $10,000 of the debentures. In January 2008, we commenced a modified dutch auction tender offer under which we offered to purchase, for cash, up to $50,000 aggregate principal amount of the debentures at a price not greater than $0.75 nor less than $0.68 per $1 principal amount. The tender offer expired on February 28, 2008 and we repurchased $50,248 principal amount of the debentures, which included $248 that we purchased without extending the tender offer in accordance with applicable securities laws. The purchase price was $0.74 per $1. We recognized a net gain of $11,557 on the repurchase, which included the $13,064 discount, offset by legal and professional fees of $755 and a write-off of debt issuance costs of $752.

The remaining $89,752 of 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 1,228,489 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.

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 $89,752 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. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

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Shareholders Equity (Deficit)

Reverse Stock Split

On June 4, 2008, we effected a one-for-three reverse split of our common stock. The exercise price and number of shares of common stock issuable under our stock incentive plans, as well as the conversion price and number of shares issuable upon conversion of our long-term debt were proportionately adjusted to reflect the reverse stock split. Basic and diluted weighted average shares outstanding and earnings per share have been calculated to reflect the reverse stock split in all periods presented.

Share Repurchase Program

On September 25, 2007, we announced a share repurchase program under which the Board of Directors authorized the repurchase of up to $10,000 of our common stock over the next twelve months. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion. Share repurchases under the program may be made through open market and privately negotiated transactions at our discretion, subject to market conditions and other factors. During 2007, we repurchased 1,260,833 common shares at a cost of $4,269. During the first half of 2008, we repurchased 607,737 shares for $1,371. As of June 30, 2008, $4,360 remained available for repurchase under the plan. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

NOTE 3: FAIR VALUE MEASUREMENT

On January 1, 2008, we adopted FASB Statement of Financial Accounting Standard No. (SFAS) 157, *Fair Value Measurement* (SFAS 157) for our financial assets and liabilities. SFAS 157 defines fair value and describes three levels of inputs that 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 observable inputs other than quoted prices in active markets for identical assets and liabilities.

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.

The table below presents information about our financial assets and liabilities measured at fair value at June 30, 2008:

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	Level 1	Level 2	Level 3	Total
Cash equivalents	$ 46,637	$		$ 46,637
Short-term marketable securities		14,804		14,804
Long-term marketable securities	2,910	4,585		7,495
Total	$ 49,547	$ 19,389		$ 68,936

Level 1 financial assets include money market funds and a long term equity security. Level two financial assets include commercial paper, corporate debt securities and U.S. government agencies debt securities. We primarily use the market approach to determine the fair value of our financial assets.

The adoption of SFAS 157 for financial assets and financial liabilities did not have a material impact on our consolidated financial statements. FSP 157-2 *Partial Deferral of the Effective Date of Statement 157* (FSP 157-2) deferred the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008. We will adopt FSP 157-2 on January 1, 2009, and do not expect the adoption to have a material impact on our consolidated financial statements.

On January 1, 2008, we adopted SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 allows us to measure many financial instruments and certain other items at fair value. 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 PLANS

In 2006, we initiated restructuring plans aimed at returning the Company to profitability. We continued to implement these plans throughout 2007 and during the first half of 2008. The following is a summary of restructuring expense incurred during the six months ended June 30, 2008 and the cumulative amount incurred through June 30, 2008:

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	Six Months Ended June 30, 2008		Cumulative Amount Incurred To June 30, 2008	
Cost of revenue restructuring:				
Termination and retention benefits	$		$	219
Licensed technology and tooling write-offs				2,072
				2,291
Operating expenses restructuring:				
Consolidation of leased space		494		3,054
Termination and retention benefits		356		8,338
Net write off of assets and reversal of related liabilities				13,451
Contract termination fee				1,693
Payments, non-cancelable contracts				827
Other				88
		850		27,451
Total restructuring expense	$	850	$	29,742

The following is a summary of the change in accrued liabilities related to the restructuring plans during the first half of 2008:

	Balance as of December 31, 2007		Expensed		Payments		Balance as of June 30, 2008	
Termination and retention benefits	$	1,758	$	356	$	(1,747)	$	367
Lease termination costs		999		494		(542)		951
Contract termination and other costs		514				(514)		
Total	$	3,271	$	850	$	(2,803)	$	1,318

NOTE 5: INCOME TAXES

The provision (benefit) for income taxes recorded for the three and six month periods ended June 30, 2008 and 2007 includes current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. Additionally, during the first quarter of 2008, we recorded a benefit of $1,000 for refundable research and experimentation credits, a benefit of $559 for the reversal of a previously recorded tax contingency due to the expiration of the applicable statute of limitations, and a deferred tax benefit of $446 which resulted from an increase in the tax rate of a single foreign jurisdiction.

As of June 30, 2008, 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.

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As of June 30, 2008 and December 31, 2007, the amount of our uncertain tax positions was a liability of $10,524 and $10,635, respectively. A number of years may elapse before an uncertain tax position is resolved by settlement or statute of limitations. 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 $1,815 within the next twelve months due to the expiration of a statute of limitations in a foreign jurisdiction. We recognize interest and penalties related to uncertain tax positions in income tax expense in our consolidated statement of operations.

NOTE 6: COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss), net of tax, were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net income (loss)	$ (1,250)	$ (7,620)	$ 4,883	$ (20,042)
Reclassification adjustment from accumulated other comprehensive income for other-than-temporary loss on marketable security included in net income			4,810	
Unrealized gain (loss) on available-for-sale investments	(729)	(80)	(547)	451
Total comprehensive income (loss)	$ (1,979)	$ (7,700)	$ 9,146	$ (19,591)

NOTE 7: EARNINGS PER SHARE

We calculate earnings per share in accordance with SFAS 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and include exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 by Jaldi, our Canadian subsidiary, to its shareholders in connection with the Jaldi asset acquisition, have characteristics essentially equivalent to Pixelworks common stock. At June 30, 2008 there were no outstanding exchangeable shares. Basic and diluted weighted average shares outstanding have been calculated to reflect the June 4, 2008 one-for three reverse stock split in all periods presented.

Diluted weighted average shares outstanding includes the incremental number of common shares that would be outstanding assuming the exercise of certain stock options, when such exercise would have the effect of reducing earnings per share, and the conversion of our convertible debentures, using the if-converted method, when such conversion is dilutive.

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

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	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Net income (loss)	$ (1,250)	$ (7,620)	$ 4,883	$ (20,042)
Basic weighted average shares outstanding	14,577	16,286	14,753	16,273
Common share equivalents:				
Dilutive effect of stock options			13	
Diluted weighted average shares outstanding	14,577	16,286	14,766	16,273
Net income (loss) per common share basic and diluted	$ (0.09)	$ (0.47)	$ 0.33	$ (1.23)

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 June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Stock options	1,816	2,020	1,716	2,116
Conversion of debentures	1,228	1,916	1,467	1,916
Unvested stock awards		32		16
	3,044	3,968	3,183	4,048

NOTE 8: SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental disclosure of cash flow information is as follows:

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash paid during the period for:		
Interest	$1,121	$1,318
Income taxes	238	1,457
Non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	$1,056	$

NOTE 9: SEGMENT INFORMATION

In accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related 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.

Geographic Information

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Japan	$ 12,241	$ 15,201	$ 26,246	$ 28,194
Europe	1,965	1,419	4,342	3,067
Taiwan	2,171	2,798	4,064	5,823
Korea	2,006	1,852	3,609	4,278
U.S.	887	1,461	1,855	2,522
China	390	1,421	1,110	2,823
Other	1,133	2,744	3,543	4,170
	$ 20,793	$ 26,896	$ 44,769	$ 50,877

Significant Customers

Sales to distributors represented 47% and 63% of total revenue for the second quarter of 2008 and 2007, respectively and 50% and 59% for the first half of 2008 and 2007, respectively. One distributor represented 29% and 36% of total revenue for the second quarter of 2008 and 2007, respectively and 29% and 34% of total revenue for the first half of 2008 and 2007, respectively. No other distributor represented 10% or more of revenue during these periods.

End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and manufacturers representatives. Revenue attributable to our top five end customers represented 54% and 46% of revenue for the second quarter of 2008 and 2007, respectively, and 55% and 47% of revenue for the first half of 2008 and 2007, respectively. One end customer represented 26% and 17% of total revenue for the second quarter of 2008 and 2007, respectively and 27% and 19% of total revenue for the first half of 2008 and 2007, respectively. No other end customer represented 10% or more of revenue during these periods.

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

	June 30, 2008	December 31, 2007
Account A	27%	27%
Account B	18%	21%
Account C	10%	3%

NOTE 10: 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.

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 11: COMMITMENTS AND CONTINGENCIES

Indemnifications

Certain of our agreements include limited indemnification provisions for claims from third-parties relating to our intellectual property. Such indemnification provisions are accounted for in accordance with FASB Summary of Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others-an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No.34*. The indemnification is limited to the amount paid by the customer. As of June 30, 2008, we have not incurred any material liabilities arising from these indemnification obligations. However, in the future such obligations could immediately impact our results of operations but are not expected to materially affect our business.

Legal Proceedings

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.

NOTE 12: SUBSEQUENT EVENT

In August 2008, we purchased $15,000 of our 1.75% convertible subordinated debentures for $10,610 in cash in a combination of open market and private transactions. As a result of this transaction we will recognize a gain in other income of approximately $4,200 in the third quarter of 2008.

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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 varia 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. Actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors. Such factors include, but are not limited to, changes in growth in the multimedia projector, advanced television, advanced media processor, and liquid crystal display (LCD) panel and monitor markets; competitive factors, such as rival chip architectures, introduction or traction by competing designs, or pricing pressures; changes in customer ordering patterns or lead times; seasonality in the consumer electronics market; new product yield rates; supply of products from third party foundries; the success of our products in expanded markets; our efforts to maintain profitability and positive earnings before interest, taxes, depreciation and amortization; insufficient, excess or obsolete inventory and variations in inventory valuation; changes in the recoverability of intangible assets and long lived assets, and other risks identified in the risk factors contained 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, and, 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. Our solutions enable manufacturers of digital display and projection devices, such as multimedia projectors and large-screen LCD televisions to differentiate their products with a consistently high level of video quality.

Results of Operations

Revenue, net

Net revenue was comprised of the following amounts (dollars in thousands):

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	Three months ended June 30,		2008 v 2007		% of net revenue	
	2008	2007	$ change	% change	2008	2007
Multimedia projector	$ 12,630	$ 13,536	$ (906)	(7)%	61%	50%
Advanced television	2,677	4,465	(1,788)	(40)	13	17
Advanced media processor	2,578	4,643	(2,065)	(44)	12	17
LCD monitor, panel and other	2,908	4,252	(1,344)	(32)	14	16
Total revenue	$ 20,793	$ 26,896	$ (6,103)	(23)%	100%	100%

	Six months ended June 30,		2008 v 2007		% of net revenue	
	2008	2007	$ change	% change	2008	2007
Multimedia projector	$ 26,915	$ 26,221	$ 694	3%	60%	52%
Advanced television	5,997	10,222	(4,225)	(41)	14	20
Advanced media processor	6,421	8,583	(2,162)	(25)	14	17
LCD monitor, panel and other	5,436	5,851	(415)	(7)	12	11
Total revenue	$ 44,769	$ 50,877	$ (6,108)	(12)%	100%	100%

Multimedia Projector

Revenue from the multimedia projector market decreased 7% in the second quarter of 2008 compared to the second quarter of 2007. This decrease is due to a 3% decrease in both units sold and average selling price (ASP). Multimedia projector revenue in the first half of 2008 increased 3% compared to the first half of 2007. This increase is due to a 4% increase in units sold, partially off-set by a 1% decrease in ASP. Revenue fluctuations between 2008 and 2007 are primarily due to timing differences of sales to continuing customers.

Advanced Television

Revenue from the advanced television market decreased 40% in the second quarter of 2008 compared to the second quarter of 2007. This decrease is due to a 38% decrease in units sold and a 3% decrease in ASP. Revenue from the advanced television market decreased 41% in the first half of 2008 compared to the first half of 2007. This decrease is due to a 44% decrease in units sold, partially off-set by a 6% increase in ASP. Decreases in 2008 are primarily attributable to our decision to shift focus away from the commoditized System on Chip segment of the advanced television market. With our new strategy we are developing co-processor ICs that will improve the video performance of any image processor in the large screen, high resolution, high quality segment of the advanced television market.

Advanced Media Processor

Revenue in the advanced media processor market is attributable to products we obtained in connection with our acquisition of Equator Technologies, Inc. (Equator) in June 2005. Revenue from this market decreased 44% in the second quarter of 2008 compared to the second quarter of 2007. This decrease resulted from a 42% decrease in units sold and a 5% decrease in ASP. Revenue from this market decreased 25% in the first half of 2008 compared to the first half of 2007. This decrease resulted from a 26% decrease in units sold, partially offset by a 1% increase in ASP.

As a result of our April 2006 restructuring plan we are no longer pursuing stand-alone digital media streaming markets that are not core to our business. We expect to see revenue from this market continue to decrease over time as customers switch to next generation designs from other suppliers.

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LCD Monitor, Panel and Other

LCD monitor, panel and other revenue decreased $1.3 million in the second quarter of 2008 compared to the second quarter of 2007, and decreased $415,000 in the first half of 2008 compared to the first half of 2007. The decrease is primarily attributable to our decision to stop developing lower-end LCD monitor chips.

Cost of revenue and gross profit

Cost of revenue and gross profit were as follows (dollars in thousands):

	Three months ended June 30,			
	2008	% of revenue	2007	% of revenue
Direct product costs and related overhead [1]	$ 9,590	46%	$ 14,006	52%
Provision for obsolete inventory, net of usage	(20)	(0)	520	2
Amortization of acquired developed technology	705	3	705	3
Restructuring			35	0
Stock-based compensation	20	0	28	0
Total cost of revenue	$ 10,295	50%	$ 15,294	57%
Gross profit	$ 10,498	50%	$ 11,602	43%

	Six months ended June 30,			
	2008	% of revenue	2007	% of revenue
Direct product costs and related overhead [1]	$ 20,492	46%	$ 26,406	52%
Provision for obsolete inventory, net of usage	660	1	1,422	3
Amortization of acquired developed technology	1,410	3	1,410	3
Restructuring			136	0
Stock-based compensation	38	0	48	0
Total cost of revenue	$ 22,600	50%	$ 29,422	58%
Gross profit	$ 22,169	50%	$ 21,455	42%

[1] Includes purchased materials, assembly, test, labor, employee benefits, warranty expense and royalties.

Direct product costs and related overhead decreased to 46% of revenue in the second quarter and first half of 2008, down from 52% in the second quarter and first half of 2007. The decrease in direct product costs and related overhead as a percentage of revenue in the 2008 periods compared to the 2007 periods resulted primarily from lower pricing obtained from vendors, a more favorable mix of products sold and increases in production yields. The net provision for obsolete inventory decreased to 0% of revenue in the second quarter of 2008 from 2% in the second quarter of 2007, and to 1% in the first half of 2008 from 3% in the first half of 2007. The decrease in net provision for obsolete inventory as a percentage of revenue in the 2008 periods compared to 2007 periods is attributable to our increased focus on inventory management.

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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 June 30, 2008 and 2007 was as follows (dollars in thousands):

	Three months ended June 30,		2008 v 2007	
	2008	2007	$ change	% change
Research and development [1]	$7,193	$9,675	$(2,482)	(26)%
[1] Includes stock-based compensation expense of:	449	510		

Research and development expense decreased 26% in the second quarter of 2008 compared with the second quarter of 2007. The decrease in research and development expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

- Depreciation and amortization expense decreased $1.9 million. This decrease is primarily due to the December 31, 2007 write off of engineering software tools, which we are no longer using due to reductions in research and development personnel and changes in product development strategy.
- Facilities and information technology expense allocations decreased $381,000, primarily due to reductions in outsourced IT support and decreased equipment depreciation. These decreases are primarily due to reduced headcount.
- Compensation expense decreased $173,000. At June 30, 2008, we had 137 research and development employees compared to 186 at June 30, 2007.

Research and development expense for the six month periods ended June 30, 2008 and 2007 was as follows (dollars in thousands):

	Six months ended June 30,		2008 v 2007	
	2008	2007	$ change	% change
Research and development [1]	$13,915	$21,650	$(7,735)	(36)%
[1] Includes stock-based compensation expense of:	898	1,180		

Research and development expense decreased 36% in the first half of 2008 compared with the first half of 2007. The decrease in research and development expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

- Depreciation and amortization expense decreased $3.8 million. This decrease is primarily due to the December 31, 2007 write off of engineering software tools.

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- Compensation expense decreased $1.7 million due to fewer research and development personnel.
- Facilities and information technology expense allocations decreased $1.1 million, primarily due to reductions in outsourced IT support, lower rent and decreased equipment depreciation.
- Development-related expenses, including non-recurring engineering and outside services, decreased $547,000 as a result of our restructuring efforts.
- Stock-based compensation expense decreased $282,000 due to personnel reductions and reduced valuation of our stock options.
- Travel and related expenses decreased $278,000.

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 month periods ended June 30, 2008 and 2007 was as follows (dollars in thousands):

	Three months ended June 30,		2008 v 2007	
	2008	2007	$ change	% change
Selling, general and administrative [1]	$4,491	$7,013	$(2,522)	(36)%
[1] Includes stock-based compensation expense of:	313	916		

Selling, general and administrative expense decreased 36% in the second quarter of 2008 compared with the second quarter of 2007. The decrease in selling, general and administrative expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

- Compensation expense decreased $1.0 million. As of June 30, 2008, we had 70 employees in selling, general and administrative functions, compared to 130 as of June 30, 2007.
- Stock-based compensation expense decreased $603,000 due to personnel reductions and reduced valuation of our stock options.
- Facilities and information technology allocations decreased $274,000.
- Travel and related expenses decreased $256,000.
- Recruiting fees decreased $178,000 due to executive search charges during the second quarter of 2007.

Selling, general and administrative expense for the six month periods ended June 30, 2008 and 2007 was as follows (dollars in thousands):

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	Six months ended June 30,		2008 v 2007	
	2008	2007	$ change	% change
Selling, general and administrative [1]	$9,177	$14,538	$(5,361)	(37)%
[1] Includes stock-based compensation expense of:	738	1,949		

Selling, general and administrative expense decreased 37% in the first half of 2008 compared with the first half of 2007. The decrease in selling, general and administrative expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

- Compensation expense decreased $2.5 million due to fewer selling, general and administrative personnel.
- Stock-based compensation expense decreased $1.2 million due to personnel reductions and reduced valuation of our stock options.
- Facilities and information technology allocations decreased $585,000.
- Travel and related expenses decreased $477,000.
- Recruiting fees decreased $300,000 due to executive search charges during the first half of 2007.

Restructuring

Restructuring expense was comprised of the following amounts (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Termination and retention benefits [1]	$ (111)	$ 1,202	$ 356	$ 3,650
Consolidation of leased space [2]	(47)	883	494	891
Net write off of assets and reversal of related liabilities		523		555
Payments, non-cancelable contracts				313
Other		62		130
Total restructuring expenses	$ (158)	$ 2,670	$ 850	$ 5,539
Included in cost of revenue	$	$ 35	$	$ 136
Included in operating expenses	(158)	2,635	850	5,403

[1] Termination and retention benefits related to our restructuring plans included severance and retention payments for terminated employees and retention payments for certain

continuing employees. The benefit in the second quarter of 2008 is due to true ups of prior estimates of severance payments.

2 Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and moving expenses. The benefit in the second quarter of 2008 is due to true ups of a prior estimate.

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Amortization of acquired intangible assets

Amortization of acquired intangible assets relates to a customer relationship asset that we recorded in connection with our June 2005 Equator acquisition. Amortization of the customer relationship asset was $74,000 and $90,000 for the second quarter of 2008 and 2007, respectively and $164,000 and $180,000 for the first half of 2008 and 2007, respectively. The asset was fully amortized as of June 30, 2008.

Interest and other income, net

Interest and other income, net consisted of the following (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	2008	2007	$ change	2008	2007	$ change
Interest income [1]	$ 553	$ 1,444	$ (891)	$ 1,536	$ 2,971	$ (1,435)
Other income [2]	218		218	218		218
Interest expense [3]	(419)	(688)	269	(992)	(1,345)	353
Amortization of debt issuance costs [4]	(125)	(166)	41	(271)	(331)	60
Gain on repurchase of long-term debt, net [5]				11,557		11,557
Other-than-temporary impairment of marketable security, net [6]				(6,490)		(6,490)
Total interest and other income, net	$ 227	$ 590	$ (363)	$ 5,558	$ 1,295	$ 4,263

1 Interest income is earned on cash equivalents and short- and long-term marketable securities. The decrease in the 2008 periods is due to lower balances of marketable securities which resulted from our February 2008 repurchase of long-term debt and decreased yields on our debt securities.

2 In the second quarter of 2008, we recognized a gain of $218,000 on the sale of a non-marketable equity security.

3

Interest expense primarily relates to interest payable on our long-term debt. The decrease in the 2008 periods is due to the reduced outstanding principal balance which resulted from our February 2008 repurchase of long-term debt.

4 The fees associated with the 2004 issuance of our long-term debt have been capitalized and are being amortized over a period of seven years. The remaining amortization period is approximately three years as of June 30, 2008. The decrease in the 2008 periods is due to the write-off of fees associated with the portion of long-term debt repurchased in February 2008.

5 In February 2008, we repurchased and retired $50.2 million of our outstanding debt for $37.9 million in cash, including legal and other professional fees of $755,000. We recognized a gain on this repurchase of $11.6 million, net of a write off of debt issuance costs of $752,000.

6

In the first quarter of 2008, we recognized an other-than-temporary impairment of $6.5 million on a publicly-traded equity security, due to the duration of time that the investment had been below cost and the decline in the public stock price during the quarter. At December 31, 2007, $4.8 million unrealized loss was included in accumulated other comprehensive loss in shareholders deficit.

Provision (benefit) for income taxes

The provision (benefit) for income taxes recorded for the second quarter of 2008 and 2007 was $375,000 and $399,000, respectively and $(1.3) million and $1.0 million for the first half of 2008 and 2007, respectively. The provision (benefit) includes current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. Additionally, during the first quarter of 2008, we recorded a benefit of $1.0 million for refundable research and experimentation credits, a benefit of $559,000 for the reversal of a previously recorded tax contingency due to the expiration of the applicable statute of limitations, and a deferred tax benefit of $446,000 which resulted from an increase in the tax rate of a single foreign jurisdiction.

Business Outlook

On July 24, 2008, we provided an outlook for the third quarter of 2008 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 net loss per share in the third quarter of 2008 of $(0.17) to $0.00, based on the following estimates:

Third quarter revenue of $20.0 million to $22.0 million.

Gross profit margin of approximately 47.5% to 50.5%.

Operating expenses of $10.8 million to $11.8 million.

Nominal interest and other income, net.

Tax provision of approximately $300,000.

Liquidity and Capital Resources

Cash and short- and long-term marketable securities

Our cash and cash equivalent and short- and long-term marketable securities were as follows (dollars in thousands):

	June 30, 2008	December 31, 2007	$ change	% change
Cash and cash equivalents	$ 59,394	$ 74,572	$ (15,178)	(20)%
Short-term marketable securities	14,804	34,581	(19,777)	(57)
Long-term marketable securities	7,495	9,804	(2,309)	(24)
Total cash and marketable securities	$ 81,693	$ 118,957	$ (37,264)	(31)%

Total cash and marketable securities decreased 31% during the first half of 2008. The decrease in total cash and marketable securities during the first half of 2008 resulted primarily from $7.9 million cash flow from operations, offset by $37.9 million for the repurchase of long-term debt, $2.8 million in payments on property and equipment and other asset financing, $1.4 million for the repurchase of our common stock and $1.2 million for purchases of property and equipment and other long-term assets.

We anticipate that our existing cash and investment balances will be adequate to fund our operating and investing needs for the next twelve months and the foreseeable future. From time to time, we may evaluate acquisitions of businesses, products or technologies that complement our business. We also may repurchase additional amounts of our long-term debt or repurchase shares of our common stock, as authorized under our share repurchase program. Any such 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.

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Accounts receivable, net

Accounts receivable, net increased to $6.7 million at June 30, 2008 from $6.2 million at December 31, 2007. The average number of days sales outstanding increased to 29 days at June 30, 2008 from 21 days at December 31, 2007.

Inventories, net

Inventories, net decreased to $6.3 million at June 30, 2008 from $11.3 million at December 31, 2007. Inventory turnover on an annualized basis increased to 5.3 at March 31, 2008 from 3.9 at December 31, 2007. As of June 30, 2008, this represented approximately ten weeks of inventory on hand.

Capital resources

In 2004, we issued $150.0 million of 1.75% convertible subordinated debentures (the debentures) due 2024. In February 2006, we repurchased and retired $10.0 million of the debentures. In January 2008, we commenced a modified dutch auction tender offer under which we offered to purchase, for cash, up to $50.0 million aggregate principal amount of the debentures at a price not greater than $750 nor less than $680 per $1,000 principal amount. The tender offer expired on February 28, 2008 and we repurchased $50.2 million principal amount of the debentures, which included $248,000 that we were allowed to purchase without extending the tender offer in accordance with applicable securities laws. The purchase price was $740 per $1,000. We recognized a net gain of $11.6 million on the repurchase, which included the $13.1 million discount, offset by legal and professional fees of $755,000 and a write-off of debt issuance costs of $752,000.

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 $89.8 million 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. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

On September 25, 2007, we announced a share repurchase program under which the board of directors authorized the repurchase of up to $10.0 million of our common stock over the next twelve months. During 2007, we repurchased 1,260,833 common shares at a cost of $4.3 million. During the first half of 2008, we purchased an additional 607,737 shares at a cost of $1.3 million. As of June 30, 2008, $4.4 million remained available for repurchase under the plan. The above share numbers reflect the one-for-three reverse split of our common stock on June 4, 2008.

Contractual Payment Obligations

Our contractual obligations for 2008 and beyond are included in our Annual Report on Form 10-K for the year ended December 31, 2007, filed with the Securities and Exchange Commission (SEC) on March 12, 2008. Our obligations for 2008 and beyond have not changed materially as of June 30, 2008, except for the reduction of $50.2 million of principal amount of long-term debt that we expect the holders of the outstanding debentures to require us to purchase in 2011, as presented above in Liquidity and Capital Resources.

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.

Our primary market risk exposure is the impact of interest rate fluctuations on interest income earned on our investment portfolio. 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.

As of June 30, 2008, we had convertible subordinated debentures of $89.8 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 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. We have employees located in offices in Canada, Japan, Taiwan and the People s Republic of China and as such, a portion of our operating expenses 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 do not currently hedge against foreign currency rate fluctuations.

Item 4. Controls and Procedures.

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(d) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting which were identified in connection with management s evaluation required by Rules 13a-15(d) and 15d-15(d) under the Exchange Act, that occurred during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

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, 2007, including our consolidated financial statements and related notes, and our other filings made from time to time with the Securities and Exchange Commission.*

The June 4, 2008 one-for-three reverse split of outstanding shares of our common stock may not result in a long-term or permanent increase in the bid price of our common stock and we may be unable to maintain compliance with NASDAQ Marketplace Rules without taking additional action, which could include effecting an additional reverse stock split. If we are delisted from the NASDAQ Global Market, there may not be a market for our common stock, which could cause a decrease in the value of an investment in us 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 attempt 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 increased to over $2.00 per share immediately following the reverse split, the price has since declined and we cannot guarantee that it will remain at or above $1.00 per share. 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 negative effects. We could not guarantee that an additional reverse split would result in a long-term or permanent increase in the price of our common stock. The market might perceive a decision to effect an additional reverse split as a negative indicator of our future prospects, and as a result, the price of our common stock might decline after such a reverse split (perhaps by an even greater percentage than would have occurred in the absence of such a reverse split). An additional reverse split could also make it more difficult for us to meet certain other requirements for continued listing on the NASDAQ Global Market, including rules related to the minimum number of shares that must be in the public float, the minimum market value of the public float and the minimum number of round lot holders. Investors might consider the increased proportion of unissued authorized shares to issued shares to have an anti-takeover effect under certain circumstances by allowing for dilutive issuances which could prevent certain shareholders from changing the composition of the board, or could render tender offers for a combination with another entity more difficult to complete successfully. Additionally, customers, suppliers or employees might consider a company with low trading volume risky and might be less likely to transact business with us.

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, such as the Pink Sheets or the OTC Bulletin Board. 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. In addition, as a delisted security, our common stock would be subject to SEC rules regarding penny stock, which impose additional disclosure requirements on broker-dealers. The regulations relating to penny stocks, coupled with the typically higher cost per trade to the investor of penny stocks due to factors such as broker commissions generally representing a higher percentage of the price of a penny stock than of a higher priced stock, would further limit the ability of investors to trade in our common stock. 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, including our ability to attract and retain qualified executives and employees and to raise capital.

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

We have adopted a new 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 development of our ImageProcessor architecture for the multimedia projector market, with particular focus on adding increased performance and functionality. For the advanced television market, we are shifting 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 a co-processor IC. This strategy is designed to address the needs of the large-screen, high-resolution, high-quality segment of the advanced television market. Additionally, we are focusing our research and development efforts on new areas beyond our traditional applications, which may not result in increased revenue or gross profit.

We have designed our new strategy to help us take advantage of expected market trends. However, our expectations may not be accurate and these markets may not develop or they may take longer to develop than we expect. Additionally, developers of products may not choose to incorporate our products into their products and we cannot assure you that our customers and potential customers will accept our products quickly enough or in sufficient volume to grow revenue and gross profit. A lack of market acceptance or insufficient market acceptance would materially and adversely affect our results of operations.

If we do not achieve additional design wins in the future, our ability to grow will be seriously limited. Even if we achieve additional design wins in the future, we may not realize significant revenue from the design wins.

Our future success depends on developers of advanced display products designing our products into their systems. To achieve design wins, we must define and deliver cost-effective, innovative and integrated semiconductors. Once a supplier s products have been designed into a system, the developer may be reluctant to change its source of components due to the significant costs associated with qualifying a new supplier. Accordingly, it may be difficult for us to achieve additional design wins. The failure on our part to obtain additional design wins with leading branded manufacturers or integrators, and to successfully design, develop and introduce new products and product enhancements could seriously limit our ability to grow.

Additionally, achieving a design win does not necessarily mean that a developer will order large volumes of our products. A design win is not a binding commitment by a developer to purchase our products. Rather, it is a decision by a developer to use our products in the design process of that developer s products. Developers can choose at any time to discontinue using our products in their designs or product development efforts. If our products are chosen to be incorporated into a developer s products, we may still not realize significant revenue from that developer if that developer s products are not commercially successful or if that developer chooses to qualify, or incorporate the products of, a second source, and any of those circumstances might cause our revenue to decline.

We have incurred substantial indebtedness as a result of the sale of convertible debentures.

As of June 30, 2008, $89.8 million of our 1.75% convertible subordinated debentures due 2024 were outstanding. Although the debt obligations are due in 2024, the holders of debentures have the right to require us to purchase all or a portion of the $89.8 million debentures outstanding 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, the holders of our outstanding debentures are unlikely to convert the debentures into common stock in accordance with the existing terms of the debentures. Accordingly, we expect holders of the debentures to require us to purchase all of the outstanding debentures on May 15, 2011, the earliest date allowed. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, some of which are beyond our control. These debentures could materially and adversely affect our ability to obtain additional debt or equity financing for working capital, acquisitions or other purposes, limit our flexibility in planning for or reacting to changes in our business, reduce funds available for use in our operations and make us more vulnerable to industry downturns and competitive pressures.

Additionally, one of the covenants of the indenture governing the debentures can be interpreted such that if we are late with any of our required filings under the Securities Exchange Act of 1934, as amended (1934 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 1934 Act. Any resulting default under our debentures would have a material adverse effect on our cash position and operating results.

We may not be able to respond to the rapid technological changes in the markets in which we compete, or seek to compete, or we may not be able to comply with industry standards in the future, making our products less desirable or obsolete.

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 emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Examples of changing industry standards include the introduction of high-definition television, which includes a variety of new formats, new video decoding technology, such as H.264 or Windows Media 11, new digital receivers and displays with higher resolutions, all of which have required us to accelerate development of new products to meet these new standards. Our failure to adequately respond to such technological changes could render our products obsolete or significantly decrease our revenue.

Because of the complex nature of our semiconductor designs and associated manufacturing processes and the rapid evolution of our customers product designs, we may not be able to develop new products or product enhancements in a timely manner, which could decrease customer demand for our products and reduce our revenue.

The development of our semiconductors is highly complex. These complexities require us to employ advanced designs and manufacturing processes that are unproven. The result can be longer and less predictable development cycles. Timely introduction of new or enhanced products depends on a number of other factors, including, but not limited to:

- accurate prediction of customer requirements and evolving industry standards;

- development of advanced display technologies and capabilities;

use of advanced foundry processes and achievement of high manufacturing yields; and

market acceptance of new products.

If we are unable to successfully develop and introduce products in a timely manner, our business and results of operations will be adversely affected. We have experienced increased development time and delays in introducing new products that have resulted in significantly less revenue than originally expected for those products. Acquisitions have significantly added to the complexity of our product development efforts as we must now coordinate very complex product development programs between multiple geographically dispersed locations. Restructuring plans have also significantly affected our product development efforts. We may not be successful in timely delivery of new products with reduced numbers of employees or with newer inexperienced employees. Any such failure could cause us to lose customers or potential customers, which would decrease our revenue.

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 that would negatively affect our operating results. For example, in 2005 and 2006, we invested significant amounts in research and development efforts for projects that were ultimately canceled and for which we will not realize any revenue. In 2007, we wrote off assets with a net book value of $6.9 million, which consisted primarily of engineering software tools that we were no longer using due to reductions in research and development personnel and changes in product development strategy.

The year ended December 31, 2004 was our only year of profitability since inception and we may be unable to achieve profitability in future periods.

The year ended December 31, 2004 was our first and only year of profitability since inception. Since then, we have incurred net losses. In addition, the profitability we achieved during the first quarter of 2008 was primarily the result of gain we recognized on the repurchase of certain of our convertible subordinated debentures, and we incurred operating losses during the period. In 2006, we initiated restructuring plans, which we implemented throughout 2007 and the first half of 2008, aimed at returning the Company to profitability. We cannot be certain that these plans will be successful or that future restructuring efforts will not be necessary. We may not achieve profitability in the future and, if we do, we may not be able to sustain or increase profitability on a quarterly or annual basis. If we are not profitable in the future, we may be unable to continue our operations.

Fluctuations in our quarterly operating results make it difficult to predict our future performance and may result in volatility in the market price of our common stock.

Our quarterly operating results have varied significantly from quarter to quarter and are likely to vary in the future based on a number of factors related to our industry and the markets for our products that are difficult or impossible to predict. Some of these factors are not in our control and any of them may cause our quarterly operating results or the price of our common stock to fluctuate. These factors include, but are not limited to:

- demand for projectors and advanced televisions;
- demand and timing of orders for our products;
- the deferral of customer orders in anticipation of new products or product enhancements from us or our competitors;
- the deferral of, or reduction in, customer orders due to a reduction in our end customers demand;
- the loss of one or more of our key distributors or customers;
- changes in the available production capacity at the semiconductor fabrication foundries that manufacture our products;
- changes in the costs of manufacturing;
- our ability to provide adequate supplies of our products to customers and avoid excess inventory;
- the announcement or introduction of products and technologies by our competitors;
- changes in product mix, product pricing or distribution channels; and
- general economic conditions and economic conditions specific to the advanced display and semiconductor markets.

Fluctuations in our quarterly results could adversely affect the price of our common stock in a manner unrelated to our long-term operating performance. Because our operating results are volatile and difficult to predict, you should not rely on the results of one quarter as an indication of our future performance. Additionally, it is possible that in any future quarter our operating results will fall below the expectations of securities analysts and investors. In this event, the price of our common stock may decline significantly.

Our products are characterized by average selling prices that decline over relatively short periods of time, which will negatively affect 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. Our operating results are negatively affected when revenue or gross profit declines. 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 basis with higher selling prices or gross profits.

Because we do not have long-term commitments from our customers and plan purchases based on estimates of customer demand which may be inaccurate, we must contract for the manufacture of our products based on potentially inaccurate estimates.

Our sales are made on the basis of purchase orders rather than long-term purchase commitments. Our customers may cancel or defer purchase orders at any time. This process requires us to make numerous forecast assumptions concerning demand, each of which may introduce error into our estimates. If our customers or we overestimate demand, we may purchase components or have products manufactured that we may not be able to use or sell. As a result, we would have excess inventory, which would negatively affect our operating results. For example, we overestimated demand for certain of our products which led to charges for obsolete inventory in 2006, 2007 and the first half of 2008. Conversely, if our customers or we underestimate demand, or if sufficient manufacturing capacity is not available, we would forego revenue opportunities, lose market share and damage our customer relationships.

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 integrators reduces our ability to forecast sales accurately and increases the complexity of our business. Since our distributors act as intermediaries between us and the companies using our products, we must rely on our distributors to accurately report inventory levels and production forecasts. We must similarly rely on our integrators. Our integrators are original equipment manufacturers (OEMs) that build display devices based on specifications provided by branded suppliers. Selling to distributors and OEMs adds another layer between us and the ultimate source of demand for our products, the consumer. These arrangements require us to manage a complex supply chain and to monitor the financial condition and creditworthiness of our distributors, integrators and customers. They also make it more difficult for us to predict demand for our products. Our failure to manage one or more of these challenges 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.

Failure to manage any future expansion efforts effectively could adversely affect our business and results of operations.

To manage any future expansion efforts 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 expand quickly enough to exploit potential market opportunities. If we do not manage any future expansion efforts effectively, our operating expenses could increase more rapidly than our revenue, adversely affecting our financial condition and results of operations.

Our future success depends upon the continued services of key personnel, many of whom would be difficult to replace, and the loss of one or more of these employees could seriously harm our business by delaying product development.

We believe our success depends, in large part, upon our ability to identify, attract and retain qualified hardware and software engineers, sales, marketing, finance and managerial personnel. Competition for talented personnel is intense and we may not be able to retain our key personnel or identify, attract or retain other highly qualified personnel in the future. Because of the highly technical nature of our business, the loss of key engineering personnel could delay product introductions and significantly impair our ability to

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successfully create future products. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenue and business could be seriously harmed.

We have experienced, and may continue to experience, difficulty in hiring and retaining employees with appropriate qualifications. Currently, this risk has increased as we continue to implement restructuring plans to consolidate our operating sites and change our strategic direction. In the last two years a significant portion of our executive management team has turned over, including the Chief Executive Officer, Chief Financial Officer, Chief Technology Officer, Vice President of Sales, Vice President of Business Operations and Vice President, General Manager of China. During 2006 and 2007, we also experienced difficulties hiring and retaining qualified engineers in our Shanghai design center.

A significant amount of our revenue comes from a limited number of customers and distributors. Any decrease in revenue from, or loss of, any of these customers or distributors could significantly reduce our revenue.

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 distributors represented 50%, 57% and 52% of revenue for the first half of 2008 and the years ended December 31, 2007 and 2006, respectively. Sales to Tokyo Electron Device, or TED, our Japanese distributor, represented 29%, 33% and 26% of revenue for the first half of 2008 and years ended December 31, 2007 and 2006, respectively. Revenue attributable to our top five end customers represented 55%, 47% and 39% of revenue for the first six half of 2008 and years ended December 31, 2007 and 2006, respectively. Sales to Seiko Epson Corporation, our top end customer, represented 27%, 21% and 15% of revenue for the first half of 2008 and years ended December 31, 2007 and 2006, respectively. 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 internally-developed semiconductors, would significantly impact our revenue. For example, our loss of a key OEM customer in Europe contributed to a $45.5 million, or 51%, decrease in advanced television revenue from 2005 to 2006.

The concentration of our accounts receivable with a limited number of customers exposes us to increased credit risk and could harm our operating results and cash flows.

As of June 30, 2008 and December 31, 2007, we had three and two customers, respectively, that each represented 10% or more of accounts receivable. 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 other customer to pay future outstanding balances, would result in an operating expense and reduce our cash flows.

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 third parties that is incorporated into our products or product enhancements. We currently have access to certain key technologies owned by independent third parties, through license agreements typically granted on a product-by-by-product basis. 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 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.

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. 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 June 30, 2008 we held 78 patents and had 75 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.

Dependence on a limited number of sole-source, third-party manufacturers for our products exposes us to shortages based on capacity allocation or low manufacturing yield, errors in manufacturing, 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 contract with third-party foundries for wafer fabrication and other manufacturers for packaging, assembly and testing of our products. We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. Our wafers are fabricated by Semiconductor

Manufacturing International Corporation, Taiwan Semiconductor Manufacturing Corporation and Toshiba Corporation. The wafers used in each of our products are fabricated by only one of these manufacturers.

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 or packaging, assembly and testing contractors, 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. From time to time, our suppliers increase prices charged to produce our products with little notice. If the prices charged by our contract manufacturers increase we may increase our prices, which could harm our competitiveness.

Our requirements represent only a small portion of the total production capacity of our contract manufacturers, who have in the past re-allocated capacity to other customers even during periods of high demand for our products. We expect this may occur again in the future. If we are unable to obtain our products from our contract manufacturers on schedule, our ability to satisfy customer demand will be harmed and revenue from the sale of products may be lost or delayed. If orders for our products are cancelled, expected revenue would not be realized. For example, in the fourth quarter of 2005, one of our contract manufacturers experienced temporary manufacturing delays due to unexpected manufacturing process problems, which caused delays in delivery of our products and made it difficult for us to satisfy our customer demand. We are currently experiencing capacity related delays with one of our primary contract manufacturers that could reduce our ability to satisfy customer demand.

If we have to qualify a new foundry or packaging, assembly and testing supplier for any of our products, we may experience delays that result in lost revenue and damaged customer relationships.

Our products require manufacturing with state-of-the-art fabrication equipment and techniques. The lead-time needed to establish a relationship with a new contract manufacturer is 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, we could incur significant delays in shipping products, which may result in lost revenue and damaged customer relationships.

Manufacturers of our semiconductor products periodically discontinue older manufacturing processes, which could make our products unavailable from our current suppliers.

Semiconductor manufacturing technologies change rapidly and manufacturers typically discontinue older manufacturing processes in favor of newer ones. For instance, a portion of our products use embedded dynamic random access memory, (DRAM) technology, which requires manufacturing processes that are being phased out. We also utilize 0.18um, 0.15um and 0.13um standard logic processes, which may only be available for the next five to seven years. Once a manufacturer makes the decision to retire a manufacturing process, notice is generally given to its customers. Customers will 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 not be able to manufacture our current products. Additionally, migrating to a new, more advanced process requires significant expenditures for research and development and takes significant time. For example in the third quarter of 2006, one of our third-party foundries discontinued the manufacturing process used to produce one of our products. While we were able to place last time buy orders, we underestimated demand for this part. As a result, we had to pay additional amounts to the foundry to restart production and we were unable to fulfill customer orders in a timely manner.

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We are dependent on our foundries to implement complex 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. However, 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.

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 analog and digital signal processing 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 system applications that required us to institute additional testing. As a result of these field failures, we incurred warranty costs due to customers returning potentially affected products. Our customers have also experienced delays in receiving product shipments from us that resulted in the loss of revenue and profits. Shipments of defective products could cause us to lose customers or incur significant replacement costs, either of which would harm our business.

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 are building most of our products on a customer owned tooling basis, also known in the semiconductor industry as COT, where we directly contract the manufacture of wafers and assume the responsibility for the assembly and testing of our products. 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 uncompetitive if we increased our prices or could result in low gross profit margins if we did not increase our prices.

Shortages of materials used in the manufacturing of our products may increase our costs or limit our revenue and impair our ability to ship our products on time.

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From time to time, shortages of materials that are used in our products may occur. In particular, we may experience shortages of semiconductor wafers and packages. 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.

Shortages of other key components for our customers products could delay our ability to sell our products.

Shortages of components and other materials that are critical to the design and manufacture of our customers products could limit our sales. These components include display components, analog-to-digital converters, digital receivers and video decoders.

Integration of software with our products adds complexity and cost that may affect our ability to achieve design wins and may affect our profitability.

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 may increase 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.

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

We provide software development tools to help customers evaluate our products and bring them into production. Software development is a complex process and we are dependent on software development languages and operating systems from vendors that may compromise 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. New software development languages may not be compatible with our own, requiring significant engineering efforts to migrate our existing systems in order to be compatible with those new languages. Existing or new software development tools could make our current products obsolete or hard to use. Software development disruptions could slow our product development or cause us to lose customers and design wins.

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% of revenue for the first half of 2008 and years ended December 31, 2007 and 2006. 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;

- 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;

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

increased transaction costs related to sales transactions conducted outside of the U.S., such as charges to secure letters of credit;

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

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

outbreaks of SARS, bird flu or other pandemics in the PRC or other parts of Asia; and

difficulties in collecting outstanding accounts receivable balances.

Our presence and investment within the People s Republic of China subjects us to risks of economic and political instability in the area, which could adversely impact our results of operations.

A substantial, and potentially increasing, portion of our products are manufactured by foundries located in the PRC. In addition, a significant percentage of our employees are located in this area. Disruptions from natural disasters, health epidemics (including new outbreaks of SARS or bird flu) 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 and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to state plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot be assured that the PRC s policies for economic reforms 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.

The concentration of our manufacturers and customers in the same geographic region increases our risk that a natural disaster, labor strike or political unrest could disrupt our operations.

Most of our current manufacturers and customers are located in the PRC, Japan, Korea or Taiwan. 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.

Decreased effectiveness of share-based payment awards could adversely affect our ability to attract and retain employees, officers and directors.

We have historically used stock options and other forms of share-based payment awards as key components of our total compensation program in order to retain employees, officers and directors and to provide competitive compensation and benefit packages. In accordance with Statement of Financial

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Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123R), we began recording stock-based compensation expense for share-based awards in the first quarter of 2006. As a result, we have incurred and will continue to incur significant compensation costs associated with our share-based programs, making it more expensive for us to grant share-based payment awards to employees, officers and directors. To the extent that SFAS 123R makes it more expensive to grant stock options or to continue to have an employee stock purchase plan, we may decide to incur cash compensation costs in the future. Actions that we take to reduce stock-based compensation expense that might be more aggressive than actions implemented by our competitors could make it difficult to attract, retain and motivate employees, officers, or directors, which could adversely affect our competitive position as well as our business and results of operations. As a result of reviewing our equity compensation strategy, in 2006 we reduced the total number of options granted to employees and the number of employees who receive share-based payment awards.

We may be unable to successfully integrate any future acquisition or equity investment we make, which could disrupt our business and severely harm our financial condition.

We may not be able to successfully integrate 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. In addition, if we acquire any company with weak internal controls, it will take time to get the acquired company up to a level of operating effectiveness acceptable to us and to implement adequate internal control, management, financial and operating reporting systems. Our inability to address these risks could negatively affect our operating results.

To date, we have acquired Panstera, Inc. (Panstera) in January 2001, nDSP Corporation (nDSP) in January 2002, Jaldi Semiconductor Corporation (Jaldi) in September 2002 and Equator Technologies, Inc. (Equator) in June 2005. In March 2003, we announced the execution of a definitive merger agreement with Genesis Microchip, Inc.; however, the merger was terminated in August 2003, and we incurred $8.9 million of expenses related to the transaction.

The acquisitions of Panstera, nDSP, Jaldi and Equator contained a very high level of risk primarily because the decisions to acquire these companies were made based on unproven technological developments and, at the time of the acquisitions, we did not know if we would complete the unproven technologies or, if we did complete the technologies, if they would be commercially viable.

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

- 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;
- large and immediate write-offs; or
- decreases in cash and marketable securities that could otherwise serve as working capital.

Our operation of any acquired business will also involve numerous risks, including, but not limited to:

- problems combining the acquired operations, technologies or products;
- unanticipated costs;
- diversion of management s attention from our core business;

- adverse effects on existing business relationships with customers;
- risks associated with entering markets in which we have no or limited prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

Our acquisition of Equator has not been as successful as we had anticipated. We acquired Equator for an aggregate purchase price of $118.1 million and recorded, among other assets, $57.5 million in goodwill, $36.8 million in acquired developed technology and $4.2 million in other acquired intangible assets. However, the Equator technology has not proven as useful as we had hoped, and thus we have recorded impairment losses on goodwill and intangible assets acquired from Equator. Only $4.5 million of the developed technology acquired from Equator remains on our consolidated balance sheet as of June 30, 2008 and only a few of the Equator employees remain employed by us. Additionally, while we are continuing to provide customers with existing products, we are no longer pursuing stand-alone advanced media processor markets that are not core to our business.

Environmental laws and regulations have caused us to incur, and may cause us to continue to incur, significant expenditures to comply with applicable laws and regulations, and may cause us to incur significant 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. For example, during 2006 the European Parliament enacted the Restriction of Hazardous Substances Directive, or RoHS, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead. In 2006, we incurred increased inventory provisions as a result of the enactment of RoHS, which adversely affected our gross profit margin. Additionally during 2006, the European Parliament enacted the Waste Electrical and Electronic Equipment Directive, or WEEE Directive, which makes producers of electrical and electronic equipment financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Additionally, some jurisdictions have begun to require various levels of Electronic Product Environmental Assessment Tool (EPEAT) certification, which are based on the Institute of Electrical and Electronics Engineers 1680 standard. The highest levels of EPEAT certification restrict the usage of halogen. Although our older generation products, many of which are still shipping to customers, do contain halogen, our next generation designs do not. 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. These 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.

Risks Related to Our Industry

Insufficient supplies of advanced display components or failure of consumer demand for advanced displays and other digital display technologies to increase would impede our growth and adversely affect our business.

Our product development strategies anticipate that consumer demand for projectors, advanced televisions and other emerging display technologies will increase in the future. The success of our products is dependent on increased demand for these display technologies. The potential size of the market for products incorporating these display technologies and the timing the market s development are uncertain and will depend upon a number of factors, all of which are beyond our control. In order for the market in which we participate to grow, advanced display products must be widely available and affordable to consumers. In the past, the supply of advanced display products has been cyclical. We expect this pattern to continue. Under-capacity in the advanced display market may limit our ability to increase our revenue because our customers may limit their purchases of our products if they cannot obtain sufficient supplies of advanced display components. In addition, advanced display prices may remain high because of limited supply, and consumer demand may not grow.

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

Rapid technological change, evolving industry standards, compressed product life cycles and declining average selling prices are characteristics of our market and could have a material adverse effect on our business, financial condition and results of operations. As the overall price of advanced flat panel displays continues to fall, we may be required to offer our products to manufacturers at discounted prices due to increased price competition. At the same time, new alternative technologies and industry standards may emerge that directly compete with technologies we offer. We may be required to increase our investment in research and development at the same time that product prices are falling. In addition, even after making this investment, we cannot assure you that our technologies will be superior to those of our competitors or that our products will achieve market acceptance, whether for performance or price reasons. Failure to effectively respond to these trends could reduce the demand for our products.

We compete with specialized and diversified electronics and semiconductor companies that offer display processors or scaling components. Some of these include ATI Technologies Inc., Broadcom Corporation, i-Chips Technologies Inc., ITE Tech. Inc., Jepico Corp., Macronix International Co., Ltd., MediaTek Inc., Media Reality Technologies Inc., Micronas Semiconductor Holding AG, MStar Semiconductor, Inc., Realtek Semiconductor Corp., Renesas Technology Corp., Sigma Designs, Inc., Silicon Image, Inc., Silicon Optix Inc., STMicroelectronics N.V., Sunplus Technology Co., Ltd., Techwell, Inc., Topro Technology Inc., Trident Microsystems, Inc., Trumpion Microelectronics Inc., Weltrend Semiconductor, 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., National Semiconductor Corporation, NEC Corporation, NVIDIA Corporation, NXP Semiconductors, Samsung Electronics Co., Ltd., SANYO Electric Co., Ltd., Seiko Epson Corporation, Sharp Electronics Corporation, Sony Corporation, Texas Instruments Incorporated and Toshiba America, Inc. In addition, start-up companies may seek to compete in our markets.

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. In the future, our current or potential customers may also develop their own proprietary technologies and become our competitors. Our competitors may develop advanced technologies enabling them to offer more cost-effective products. Increased competition 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.

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

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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 and North America. The cyclical nature of the semiconductor industry has led to significant variances in product demand and production capacity. We may experience periodic fluctuations in our future financial results because of changes in industry-wide conditions.

If products incorporating our semiconductors are not compatible with computer display protocols, video standards and other devices, the market for our products will be reduced and our business prospects could be significantly limited.

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.

Other Risks

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

On June 4, 2008, we effected a one-for-three reverse split of our common stock. Though the per share price of our common stock increased to over $2.00 per share immediately after the reverse split, the price has since declined and we cannot guarantee that we will continue to meet the minimum requirements for listing on the NADAQ Global Market. If the per share price of our common stock drops below $1.00, our common stock could again become subject to the risk of being delisted and we may seek shareholder approval for an additional reverse split. Even if the per share price of our common stock remains above $1.00, investors may not be able to sell shares of our common stock at or above the price they paid due to a number of factors, including, but not limited to:

- actual or anticipated fluctuations in our operating results;
- actual reduction in our operating results due to the adoption of SFAS 123R on January 1, 2006, which requires the expensing of stock options;
- 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;
- the operating and stock price performance of other comparable companies;
- announcements of future expectations by our customers;
- changes in market valuations of other technology companies; and
- inconsistent trading volume levels of our common stock.

The stock prices of technology companies similar to Pixelworks have been highly volatile. 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. Therefore, the price of our common stock may decline, and the value of your investment may be reduced regardless of our performance. Any scenario in which investors may not be able to realize a gain when they sell our common stock would have an adverse effect on our business, financial condition and results of operations, including our ability to attract and retain qualified employees and 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;

- members of our board of directors can only be removed 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;

- the 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.

We may be unable to meet our future capital requirements, which would limit our ability to grow.

As of June 30, 2008, we had $89.8 million of unsecured convertible debentures due 2024 outstanding and $81.7 million in cash and marketable securities, resulting in a net cash deficit position. Although the obligations are due in 2024, the holders of debentures have the right to require us to purchase all or a portion of the $89.8 million debentures outstanding as of 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, the holders of our outstanding debentures are unlikely to convert the debentures to common stock in accordance with the existing terms of the debentures. Accordingly, we expect holders of the debentures to require us to purchase all of the outstanding debentures on May 15, 2011.

On September 25, 2007, we announced a share repurchase program under which the board of directors authorized the repurchase of up to $10.0 million of our common stock over the following twelve months. During 2007, we repurchased 1,260,833 common shares at a cost of $4.3 million. From January 1, 2008 through June 30, 2008, we repurchased 607,737 shares for $1.3 million. As of June 30, 2008, $4.4 million remained available for repurchase under the plan. The above share numbers reflect the one-for-three reverse split of our common stock effected on June 4, 2008.

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 generate sufficient cash flows from operations in the future to refinance or service the potential exercise of the put option on the convertible debentures. We may need, or could elect to seek, additional funding prior to that time through public or private equity or debt financing. Additional funds may not be available on terms favorable to us or our shareholders. Furthermore, 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. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements.

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

We are spending 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 the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission rules and regulations and NASDAQ Global Market rules. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of internal control over financial reporting. While we invested significant time and money in our effort to evaluate and test our internal control over financial reporting, a material weakness was identified in our internal control over financial reporting in 2004. Although the material weakness was remediated in the first quarter of 2005, there are inherent limitations to the effectiveness of any system of internal controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective controls and procedures can provide only reasonable assurance of achieving their control objectives.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following table sets forth information about shares repurchased during the second quarter of 2008 under the share repurchase program we announced on September 25, 2007 (in thousands except share and per share data). These numbers reflect the one-for-three reverse split of our common stock effected on June 4, 2008.

Period	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
April 1, 2008 - April 30, 2008		$		$ 4,533
May 1, 2007 - May 31, 2008				4,533
June 1, 2008 - June 30, 2008	76,470	2.26	76,470	4,360
Total	76,470	$ 2.26	76,470	

(1) All purchases made on the open market

pursuant to the share repurchase program announced on September 25, 2007, under which the board of directors authorized the repurchase of up to $10.0 million of our common stock over the next twelve months. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion.

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Share repurchases under the program may be made through open market or privately negotiated transactions at our discretion, subject to market conditions and other factors.

Item 4. Submission of Matters to a Vote of Security Holders.

The 2008 Annual Meeting of Shareholders of Pixelworks, Inc. was held on May 20, 2008 to conduct the following items of business:

1. To elect seven Directors to serve one-year terms and until their successors are duly elected and qualified;

2. Approval of amendment to the 2006 Stock Incentive Plan;

3. Grant of discretionary authority to the Board of Directors to amend the articles of incorporation of the Company to effect a reverse stock split at an exchange ratio within the specified range and at any time on or prior to the date of the 2009 Annual Meeting of Shareholders;

4. To ratify the appointment of KPMG LLP as Pixelworks independent registered public accounting firm for the current fiscal year; and

5. To transact any other business that properly came before the meeting or any postponement or adjournment of the meeting.

The following nominees were elected to serve on the board of directors by the votes and for terms indicated below:

Nominee	For	Withheld	Term Ending
Allen H. Alley	34,129,508	4,353,922	2009
Mark A. Christensen	33,941,203	4,542,227	2009
James R. Fiebiger	33,561,466	4,921,964	2009
C. Scott Gibson	33,673,903	4,809,527	2009
Daniel J. Heneghan	33,947,153	4,536,277	2009
Hans H. Olsen	34,205,186	4,278,244	2009
Bruce A.Walicek	34,648,155	3,835,275	2009

The proposal to approve an amendment to the 2006 Stock Incentive Plan was approved and received the following votes:

	No. of Votes
For	12,588,912
Against	2,100,839
Abstain	44,055
Broker Non-Votes	23,749,624

The proposal to grant discretionary authority to the Board of Directors to amend the articles of incorporation of the Company to effect a reverse stock split at an exchange ratio within the specified range and at any time on or prior to the date of the 2009 Annual Meeting of Shareholders was approved and received the following votes:

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	No. of Votes
For	35,644,133
Against	2,638,141
Abstain	201,155

The proposal to ratify the appointment of KPMG LLP as Pixelworks independent registered public accounting firm for the current fiscal year was approved and received the following votes:

	No. of Votes
For	36,415,572
Against	1,924,888
Abstain	142,969

There were no other matters of business that properly came before the meeting that were voted upon.

Item 6. Exhibits.

3.1 Third Amendment to Sixth Amended and Restated Articles of Incorporation of Pixelworks, Inc.

10.1 Pixelworks, Inc. 2008 Senior Management Bonus Plan. +

10.2 Amended and Restated 2006 Stock Incentive Plan. +

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.

+ Indicates a management contract or compensation arrangement.

* 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.

PIXELWORKS, INC.

Dated: August 11, 2008

/s/ Steven L. Moore
Steven L. Moore
Vice President, Chief Financial Officer, Secretary and Treasurer

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