PIXELWORKS, INC
Form 10-Q
November 02, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012
or

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

For the transition period from to .
Commission File Number: 000-30269

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

OREGON (State or other jurisdiction of incorporation or organization)	91-1761992 (I.R.S. Employer Identification No.)
224 Airport Parkway, Suite 400 San Jose, California	95110
(Address of principal executive offices)	(Zip Code)

(408) 200-9200
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 past 90 days. Yes x No ¨

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

Number of shares of Common Stock outstanding as of October 31, 2012: 18,400,783

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$15,566	$15,092
Accounts receivable, net	3,756	4,557
Inventories	4,729	4,107
Prepaid expenses and other current assets	2,176	2,341
Total current assets	26,227	26,097
Property and equipment, net	7,019	7,366
Other assets, net	1,918	2,914
Total assets	$35,164	$36,377
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$4,347	$4,428
Accrued liabilities and current portion of long-term liabilities	9,183	8,247
Current portion of income taxes payable	129	212
Total current liabilities	13,659	12,887
Long-term liabilities, net of current portion	1,729	2,467
Income taxes payable, net of current portion	2,139	3,223
Total liabilities	17,527	18,577
Commitments and contingencies (Note 11)		
Shareholders' equity:		
Preferred stock	—	—
Common stock	348,897	346,923
Accumulated other comprehensive loss	(67)	(67)
Accumulated deficit	(331,193)	(329,056)
Total shareholders' equity	17,637	17,800
Total liabilities and shareholders' equity	$35,164	$36,377

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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue, net	$16,285	$17,391	$46,139	$47,781
Cost of revenue (1)	8,497	8,935	22,883	25,334
Gross profit	7,788	8,456	23,256	22,447
Operating expenses:				
Research and development (2)	4,702	5,982	14,510	17,531
Selling, general and administrative (3)	3,557	3,641	11,368	11,132
Total operating expenses	8,259	9,623	25,878	28,663
Loss from operations	(471)	(1,167)	(2,622)	(6,216)
Interest expense and other, net	(105)	(89)	(304)	(395)
Gain on sale of patents	—	—	—	1,600
Gain on sale of marketable securities	—	—	—	264
Total other income (expense), net	(105)	(89)	(304)	1,469
Loss before income taxes	(576)	(1,256)	(2,926)	(4,747)
Benefit for income taxes	(176)	(173)	(789)	(138)
Net loss	$(400)	$(1,083)	$(2,137)	$(4,609)
Net loss per share - basic and diluted	$(0.02)	$(0.06)	$(0.12)	$(0.29)
Weighted average shares outstanding - basic and diluted	18,338	17,905	18,202	15,787
(1) Includes:				
Additional amortization of non-cancelable prepaid royalty	$142	$103	$430	$321
Stock-based compensation	42	34	118	93
(2) Includes stock-based compensation	214	214	619	624
(3) Includes stock-based compensation	296	260	793	771

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net loss	$(400)	$(1,083)	$(2,137)	$(4,609)
Other comprehensive income (loss):				
Reclassification of unrealized gain upon sale of available-for-sale securities	—	—	—	(255)
Unrealized loss on available-for-sale securities	—	—	—	(2)
Tax effect of unrealized gain on available-for-sale securities	—	—	—	26
Total comprehensive loss	$(400)	$(1,083)	$(2,137)	$(4,840)

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net loss	$(2,137)	$(4,609)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,541	3,800
Stock-based compensation	1,530	1,488
Reversal of uncertain tax positions	(1,421)	(967)
Loss on asset disposal	187	—
Gain on sale of patents	—	(1,600)
Gain on sale of marketable securities	—	(264)
Deferred income tax expense	—	69
Other non-cash tax expense	—	26
Other	42	89
Changes in operating assets and liabilities:		
Accounts receivable, net	801	130
Inventories	(622)	175
Prepaid expenses and other current and long-term assets, net	583	808
Accounts payable	(611)	787
Accrued current and long-term liabilities	610	(167)
Income taxes payable	256	195
Net cash provided by (used in) operating activities	2,759	(40)
Cash flows from investing activities:		
Purchases of property and equipment	(1,275)	(2,017)
Proceeds from sales and maturities of marketable securities	—	12,961
Proceeds from sale of patents	—	1,600
Net cash provided by (used in) investing activities	(1,275)	12,544
Cash flows from financing activities:		
Payments on asset financings	(1,454)	(2,219)
Proceeds from issuances of common stock	444	312
Repurchase of debentures	—	(15,779)
Net proceeds from equity offering	—	8,327
Payments on line of credit	—	(3,000)
Net cash used in financing activities	(1,010)	(12,359)
Net change in cash and cash equivalents	474	145
Cash and cash equivalents, beginning of period	15,092	16,872
Cash and cash equivalents, end of period	$15,566	$17,017

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share data)
(Unaudited)

NOTE 1: BASIS OF PRESENTATION

Nature of Business

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications and hold 117 patents related to the visual display of digital image data. Our solutions enable manufacturers of digital display and projection devices, such as large-screen flat panel televisions and digital front projectors, to manufacture their products with a consistently high level of video quality, regardless of the content's source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation.

Our business also includes the license of technologies developed for our integrated circuit ("IC") semiconductor products to non-competitive customers and partners, as well as co-development arrangements with current or prospective IC customers. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

Condensed Consolidated Financial Statements

The financial information included herein for the three and nine month periods ended September 30, 2012 and 2011 is prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and is unaudited. In our opinion, such information reflects all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the Company's condensed consolidated financial statements for these interim periods. The financial information as of December 31, 2011 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2011, included in Item 8 of our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 8, 2012, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2012.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (Topic 820)-Fair Value Measurement ("ASU 2011-04"), to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements. The provisions of this new guidance are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted ASU 2011-04 effective January 1, 2012 and the adoption did not have a material impact on our consolidated financial position or results of operations.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, Comprehensive Income (Topic 220)-Presentation of Comprehensive Income ("ASU 2011-05"), to require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity. The provisions of this new guidance require retrospective application and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted ASU 2011-05 effective January 1, 2012 and elected to present comprehensive income and its components in two separate, consecutive statements.

Reclassifications

Certain reclassifications have been made to the 2011 notes to the condensed consolidated financial statements to conform to the 2012 presentation.

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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 revenue recognition, product returns, warranty obligations, bad debts, inventories, property and equipment, impairment of long-lived assets, amortization of prepaid royalties, valuation of share-based payments, income taxes, litigation and other contingencies. The actual results experienced could differ materially from our estimates.

NOTE 2: BALANCE SHEET COMPONENTS

Marketable Securities

As of September 30, 2012 and December 31, 2011, our short- and long-term marketable securities balances were zero. During the nine months ended September 30, 2011, we sold the remaining portion of our long-term equity investment. We determined the cost of the securities sold using specific identification. Net unrealized holding gains of $255 on available-for-sale securities were reclassified out of accumulated other comprehensive income (loss) for the nine months ended September 30, 2011. Unrealized holding gains and losses are recorded in accumulated other comprehensive income (loss), a component of shareholders' equity, in the condensed consolidated balance sheets.

Accounts Receivable, Net

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

Accounts receivable consists of the following:

	September 30, 2012	December 31, 2011
Accounts receivable, gross	$4,124	$4,918
Less: allowance for doubtful accounts	(368)	(361)
Accounts receivable, net	$3,756	$4,557

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

	Nine Months Ended September 30,	
	2012	2011
Balance at beginning of period	$361	$399
Additions charged (reductions credited)	7	(6)
Balance at end of period	$368	$393

Inventories

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).

Inventories consist of the following:

	September 30, 2012	December 31, 2011
Finished goods	$1,702	$1,203
Work-in-process	3,027	2,904
Total	$4,729	$4,107

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Property and Equipment, Net

Property and equipment consists of the following:

	September 30, 2012	December 31, 2011
Gross carrying amount	$23,008	$21,661
Less: accumulated depreciation and amortization	(15,989)	(14,295)
Property and equipment, net	$7,019	$7,366

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	September 30, 2012	December 31, 2011
Accrued payroll and related liabilities	$2,777	$2,638
Current portion of accrued liabilities for asset financings	1,898	1,753
Accrued commissions and royalties	1,630	1,407
Accrued interest payable	725	520
Reserve for warranty returns	505	439
Other	1,648	1,490
Total	$9,183	$8,247

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

	Nine Months Ended September 30,	
	2012	2011
Reserve for warranty returns:		
Balance at beginning of period	$439	$723
Provision (benefit)	485	(139)
Charge-offs	(419)	(194)
Balance at end of period	$505	$390

Short-Term Line of Credit

On December 21, 2010, we entered into a Loan and Security Agreement (the "Revolving Loan Agreement") with Silicon Valley Bank (the "Bank"). The Revolving Loan Agreement provides for a secured working capital-based revolving line of credit (the "Revolving Line") in an aggregate amount of up to the lesser of (i) $10,000, or (ii) 80% of eligible domestic accounts receivable and certain foreign accounts receivable. In addition, the Revolving Loan Agreement provides for non-formula advances of up to $10,000 which may be made solely during the last five business days of any fiscal month or quarter and which must be repaid by the Company on or before the fifth business day after the applicable fiscal month or quarter end. Due to their repayment terms, non-formula advances do not provide the Company with usable liquidity.

The Revolving Loan Agreement contains customary affirmative and negative covenants as well as customary events of default. The occurrence of an event of default could result in the acceleration of the Company's obligations under the Revolving Loan Agreement and an increase to the applicable interest rate, and would permit the Bank to exercise remedies with respect to its security interest. As of September 30, 2012 we were in compliance with all of the terms of the Revolving Loan Agreement.

As of September 30, 2012 and December 31, 2011, we had no outstanding borrowings under the Revolving Line.

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NOTE 3: FAIR VALUE MEASUREMENTS

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

Level 1: Valuations based on quoted prices in active markets for identical assets and liabilities.

Level 2: Valuations based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3: Valuations based on unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

The following table presents information about our assets measured at fair value on a recurring basis in the condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011:

	Level 1	Level 2	Level 3	Total
As of September 30, 2012:				
Money market funds	$14,954	$—	$—	$14,954
As of December 31, 2011:				
Money market funds	$9,111	$—	$—	$9,111

We primarily use the market approach to determine the fair value of our financial assets. The fair value of our current assets and liabilities, including accounts receivable and accounts payable approximates the carrying value due to the short-term nature of these balances. 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: RESEARCH AND DEVELOPMENT

During the second quarter of 2012, we entered into a best efforts co-development agreement (the "Co-development Agreement") with a customer to defray a portion of the research and development expenses we expect to incur in connection with our development of an IC product to be sold exclusively to the customer. We expect our development costs to exceed the amounts received from the customer under the Co-development Agreement, and although we expect to sell units of the product to the customer, there is no commitment or agreement from the customer for such sales at this time. Additionally, we retain ownership of any modifications or improvements to our pre-existing intellectual property and may use such improvements in products sold to other customers.

The initial $3,500 due under the Co-development Agreement was received within sixty days of contract signing and two additional payments of $1,750 are each payable upon completion of certain development milestones. As amounts become due and payable without recourse, they are offset against research and development expense up to the amount of related costs incurred. We recognized an offset to research and development expense of $3,063 and $437 during the third and second quarters of 2012, respectively.

NOTE 5: INCOME TAXES

The benefit for income taxes during the 2012 and 2011 periods is primarily due to the reversal of previously recorded foreign tax contingencies due to the expiration of the applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. We recorded a benefit for the reversal of previously recorded tax contingencies of $1,421 and $967 during the first nine months of 2012 and the first nine months of 2011, respectively.

As we do not believe that it is more likely than not that we will realize a benefit from our U.S. net deferred tax assets, including our U.S. net operating losses, we continue to provide a full valuation allowance against essentially all of those assets, therefore, we do not incur significant U.S. income tax expense or benefit. 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 September 30, 2012 and December 31, 2011, the amount of our uncertain tax positions was a liability of $1,955 and $3,105, respectively. A number of years may elapse before an uncertain tax position is resolved by settlement or statute of limitation. Settlement of any particular position could require the use of cash. If the uncertain tax positions we have accrued for are sustained by the taxing authorities in our favor, the reduction of the liability will reduce our effective tax rate. We reasonably expect reductions in the liability for unrecognized tax benefits and interest and penalties of approximately $390 within the next twelve months due to the expiration of a statute of limitation in a foreign jurisdiction. We recognize interest and penalties related to uncertain tax positions in income tax expense in our consolidated statements of operations.

NOTE 6: INTEREST EXPENSE AND OTHER, NET

Interest expense and other, consists of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest expense	$(106)	$(90)	$(308)	$(378)
Amortization of debt issuance costs	—	—	—	(31)
Interest income	1	1	4	14
Total interest expense and other, net	$(105)	$(89)	$(304)	$(395)

NOTE 7: EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted net loss per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net loss	$(400)	$(1,083)	$(2,137)	$(4,609)
Shares used in computing net loss per share - basic and diluted	18,338	17,905	18,202	15,787
Net loss per common share - basic and diluted	$(0.02)	$(0.06)	$(0.12)	$(0.29)

The increase in shares from the first nine months of 2011 compared to the first nine months of 2012 is primarily due to the sale of approximately 4,198 shares of common stock in an underwritten registered offering during May 2011.

The following weighted average shares were excluded from the calculation of diluted net loss per share as their effect would have been anti-dilutive:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Employee equity incentive plans	4,178	3,798	4,038	3,715

Potentially dilutive common shares from employee equity incentive plans are determined by applying the treasury stock method to the assumed exercise of outstanding stock options, the assumed vesting of outstanding restricted stock awards and units, and the assumed issuance of common stock under the employee stock purchase plan.

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NOTE 8: SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental disclosure of cash flow information is as follows:

	Nine Months Ended September 30,	
	2012	2011
Cash paid during the period for:		
Interest	$92	$234
Income taxes	352	472
Non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	$1,231	$2,457

NOTE 9: SEGMENT INFORMATION

We have identified a single operating segment: the design and development of ICs for use in electronic display devices. A majority of our assets are located in the United States.

Geographic Information

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Japan	$10,321	$12,024	$26,681	$32,090
Taiwan	3,034	2,939	7,632	7,883
United States	1,056	410	5,836	1,177
China	741	687	2,584	1,787
Europe	445	541	1,264	1,879
Korea	206	306	787	1,319
Other	482	484	1,355	1,646
	$16,285	$17,391	$46,139	$47,781

Significant Customers

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Distributors:				
All distributors	78 %	75 %	71 %	69 %
Distributor A	52 %	58 %	50 %	52 %
End customers: [1]				
Top five end customers	56 %	55 %	54 %	55 %
End customer A	19 %	15 %	17 %	13 %
End customer B	17 %	16 %	14 %	13 %
End customer C	5 %	11 %	5 %	15 %

[1] End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors.

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

	September 30, 2012		December 31, 2011	
Account A	19	%	54	%
Account B	13	%	—	%
Account C	12	%	—	%
Account D	11	%	6	%
Account E	6	%	10	%

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

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

Concentrations of Credit Risk
Financial instruments that potentially subject us to concentrations of credit risk consist of cash equivalents and accounts receivable. We limit our exposure to credit risk associated with cash equivalent balances by holding our funds in high quality, highly liquid money market accounts. 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 indemnification provisions for claims from third-parties relating to our intellectual property. It is not possible for us to predict the maximum potential amount of future payments or indemnification costs under these or similar agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each particular agreement. We have not made any payments under these agreements in the past, and as of September 30, 2012, we have not incurred any material liabilities arising from these indemnification obligations. In the future, however, such obligations could materially impact our results of operations.

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.

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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 variations words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict and which may cause actual outcomes and results to differ materially from what is expressed or forecasted in such forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in Part II, Item 1A of this Quarterly Report on Form 10-Q. These forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q. If we do update or correct one or more forward-looking statements, you should not conclude that we will make additional updates or corrections with respect thereto or with respect to other forward-looking statements. Except where the context otherwise requires, in this Quarterly Report on Form 10-Q, the “Company,” “Pixelworks,” “we,” “us” and “our” refer to Pixelworks, Inc., an Oregon corporation, and its wholly-owned subsidiaries.

Overview

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications and hold 117 patents related to the visual display of digital image data. Our solutions enable manufacturers of digital display and projection devices, such as large-screen flat panel televisions and digital front projectors, to manufacture their products with a consistently high level of video quality, regardless of the content’s source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation.

Our business also includes the license of technologies developed for our integrated circuit ("IC") semiconductor products to non-competitive customers and partners, as well as co-development arrangements with current or prospective IC customers. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

Results of Operations

Revenue, net

Net revenue for the three and nine month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2012	2011	% Change	2012	2011	% Change
Revenue, net	$16,285	$17,391	(6)%	$46,139	$47,781	(3)%

Net revenue decreased $1.1 million, or 6%, from the third quarter of 2011 to the third quarter of 2012, and decreased $1.6 million, or 3%, from the first nine months of 2011 to the first nine months of 2012. Revenue related to IC product sales was $15.7 million and $17.3 million for the third quarter of 2012 and 2011, respectively and was $41.1 million and $47.8 million for the first nine months of 2012 and 2011, respectively. Revenue related to licensing agreements was $0.6 million and $5.0 million for the third quarter and first nine months of 2012, respectively. The 2011 periods did not include any revenue associated with licensing agreements.

The decrease in revenue related to IC product sales was primarily attributable to a 15% decrease in average selling price (“ASP”), during the 2012 periods compared to the 2011 periods. This decrease in ASP was partially offset by a 7% increase in units sold during the third quarter of 2012 compared to the third quarter of 2011. Total units sold during the first nine months of 2011 compared to the first nine months of 2012 were relatively unchanged.

The decreases in ASP were primarily due to a greater proportion of unit sales of our latest generation MotionEngine® co-processor ICs, which have lower price points than our other product lines. The decrease was also attributable to reduced pricing on our earlier generation digital projector products.

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The increase in units sold during the third quarter of 2012 compared to the third quarter of 2011 was primarily due to increased sales of our MotionEngine® co-processor IC products into the advanced television market, partially offset by a decrease in sales of our earlier generation digital projector products due to competitive factors affecting customer transition to next generation digital projector solutions.

We anticipate that macro-economic weaknesses and seasonality will contribute to reduced revenue for the fourth quarter of 2012, compared to the third quarter of 2012. We have historically experienced higher revenue from the digital projector market during the third quarter of the year and lower revenue during the first quarter of the year, as our Japanese customers reduce inventories in anticipation of their March 31 fiscal year end.

Cost of revenue and gross profit

Cost of revenue and gross profit for the three month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Three Months Ended September 30,						
	2012	% of revenue		2011		% of revenue	
Direct product costs and related overhead [1]	$8,016	49	%	$8,800		51	%
Licensing costs [2]	297	2		—		0	
Inventory charges [3]	—	0		(2	)	0	
Other cost of revenue [4]	184	1		137		1	
Total cost of revenue	$8,497	52	%	$8,935		51	%
Gross profit	$7,788	48	%	$8,456		49	%

1 Includes purchased materials, assembly, test, labor, employee benefits, warranty expense and royalties, all of which are related to sales of IC products.

2 Includes direct labor costs and allocated overhead associated with license revenue arrangements.

3 Includes a benefit for sales of previously written down inventory.

4 Includes stock based compensation and additional amortization of a non-cancelable prepaid royalty.

Gross profit margin decreased to 48% of revenue during the third quarter of 2012, down from 49% of revenue in the third quarter of 2011. Excluding the impact of license revenue, direct product costs and related overhead as a percentage of revenue were approximately 51% during the third quarter of 2011 and the third quarter of 2012, reflecting reduced ASPs and product costs as well as offsetting fluctuations in product mix. Gross profit margin on our license revenue during the third quarter of 2012 was consistent with our overall gross profit margin during the third quarter of 2012 and 2011.

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Cost of revenue and gross profit for the nine month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Nine Months Ended September 30,					
	2012	% of revenue		2011	% of revenue	
Direct product costs and related overhead [1]	$21,544	47	%	$24,620	52	%
Licensing costs [2]	802	2		—	0	
Inventory charges [3]	(11)	0		300	1	
Other cost of revenue [4]	548	1		414	1	
Total cost of revenue	$22,883	50	%	$25,334	53	%
Gross profit	$23,256	50	%	$22,447	47	%

1 Includes purchased materials, assembly, test, labor, employee benefits, warranty expense and royalties, all of which are related to sales of IC products.

2 Includes direct labor costs and allocated overhead associated with license revenue arrangements.

3 Includes charges to reduce inventory to lower of cost or market less a benefit for sales of previously written down inventory.

4 Includes stock based compensation and additional amortization of a non-cancelable prepaid royalty.

Gross profit margin increased to 50% of revenue in the first nine months of 2012, up from 47% of revenue in the first nine months of 2011. This increase was due primarily to the recognition of higher margin license revenue during the first nine months of 2012. The favorable impact of licensing revenue on gross margin was partially offset by non-recurring charges related to a discontinued product and increased warranty returns during the first nine months of 2012. Additionally, direct product costs and related overhead as a percentage of revenue during the first nine months of 2012 compared to the first nine months of 2011 reflected reduced ASPs and product costs as well as offsetting fluctuations in product mix.

Pixelworks' gross margin is subject to variability based on changes in revenue levels, recognition of license revenue, product mix, ASPs, startup costs, and the timing and execution of manufacturing ramps as well as other factors.

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.

Co-development agreement

During the second quarter of 2012, we entered into a best efforts co-development agreement (the "Co-development Agreement") with a customer to defray a portion of the research and development expenses we expect to incur in connection with our development of an IC product to be sold exclusively to the customer. We expect our development costs to exceed the amounts received from the customer under the Co-development Agreement, and although we expect to sell units of the product to the customer, there is no commitment or agreement from the customer for such sales at this time. Additionally, we retain ownership of any modifications or improvements to our pre-existing intellectual property and may use such improvements in products sold to other customers.

The initial $3.5 million due under the Co-development Agreement was received within sixty days of contract signing and two additional payments of $1.75 million are each payable upon completion of certain development milestones. As amounts become due and payable without recourse, they are offset against research and development expense up to the amount of related costs incurred. We recognized an offset to research and development expense of $3.1 million and $0.4 million during the third and second quarters of 2012, respectively.

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2012 v. 2011

Research and development expense for the three month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Three Months Ended September 30,		2012 v. 2011	
	2012	2011	$ Change	% Change
Research and development	$4,702	$5,982	$(1,280)	(21)%

Research and development expense decreased $1.3 million, or 21%, from the third quarter of 2011 to the third quarter of 2012. The decrease was primarily attributable to a benefit of $3.1 million recognized in the third quarter of 2012 offset by an increase in non-recurring engineering expense of $1.6 million. The benefit recognized and the increase in non-recurring engineering expense are both related to the Co-development Agreement. The decrease was also partially offset by an increase to compensation expense due to an increase in headcount and variable compensation expense.

Research and development expense for the nine month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Nine Months Ended September 30,		2012 v. 2011	
	2012	2011	$ Change	% Change
Research and development	$14,510	$17,531	$(3,021)	(17)%

Research and development expense decreased $3.0 million, or 17%, from the first nine months of 2011 to the first nine months of 2012. The decrease was primarily attributable to a benefit of $3.5 million recognized in the first nine months of 2012 offset by an increase in non-recurring engineering expense of $1.0 million. The benefit recognized and the increase in non-recurring engineering expense are both related to the Co-development Agreement. The decrease was also attributable to a $0.5 million reduction in direct labor costs and allocated overhead associated with the utilization of research and development engineers on license revenue agreements; these costs were recorded in cost of revenue. These decreases were partially offset by an increase to compensation expense due to an increase in headcount and variable compensation expense.

We anticipate an increase in research and development expense for the fourth quarter of 2012 compared to the third quarter of 2012 as we continue to incur expenses related to the Co-development Agreement and do not expect to recognize additional offsets to research and development expense until the completion of certain development milestones in 2013.

Selling, general and administrative

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

Selling, general and administrative expense for the three and nine month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Three Months Ended September 30,		2012 v. 2011	Nine Months Ended September 30,		2012 v. 2011
	2012	2011	% Change	2012	2011	% Change
Selling, general and administrative	$3,557	$3,641	(2)%	$11,368	$11,132	2 %

Selling, general and administrative expense decreased $0.1 million, or 2%, from the third quarter of 2011 to the third quarter of 2012, and increased $0.2 million, or 2%, from the first nine months of 2011 to the first nine months of

2012. The decrease from the third quarter of 2011 to the third quarter of 2012 was primarily due to a decrease in compensation expense resulting from reduced headcount. The increase from the first nine months of 2011 to the first nine months of 2012 was primarily due to increased non-recurring legal expenses and variable compensation expense, partially offset by reduced headcount.

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Other income (expense), net

Net other income (expense) for the three and nine month periods ended September 30, 2012 and 2011, was as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2012	2011	$ Change	2012	2011	$ Change
Interest expense and other, net [1]	$(105)	$(89)	$(16)	$(304)	$(395)	$91
Gain on sale of patents [2]	—	—	—	—	1,600	(1,600)
Gain on sale of marketable securities	—	—	—	—	264	(264)
Total other income (expense), net	$(105)	$(89)	$(16)	$(304)	$1,469	$(1,773)

1 Interest expense and other, net consists of interest expense, interest income and amortization of debt issuance costs. The decrease from the first nine months of 2011 to the first nine months of 2012 was primarily due to a decrease in interest expense and amortization of debt issuance costs attributable to the repayment of our convertible subordinated debentures in the second quarter of 2011.

2 In the first quarter of 2011, we sold certain patents and related rights and materials for proceeds and a net gain of $1.6 million. All of the patents were originally obtained by us during our June 2005 acquisition of Equator Technologies, Inc., and the underlying technologies pertain to markets that we no longer pursue.

Benefit for income taxes

The benefit for income taxes during the 2012 and 2011 periods is primarily due to the reversal of previously recorded foreign tax contingencies due to the expiration of the applicable statutes of limitation, partially offset by current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. Due to the full valuation allowance on our U.S. net deferred tax assets, including our U.S. net operating losses, we do not incur significant U.S. income tax expense or benefit. We recorded a benefit for the reversal of previously recorded tax contingencies of $1.4 million and $1.0 million during the first nine months of 2012 and the first nine months of 2011, respectively.

Liquidity and Capital Resources

Cash and cash equivalents

Total cash and cash equivalents increased from $15.1 million at December 31, 2011 to $15.6 million at September 30, 2012. The net increase during the first nine months of 2012 resulted from $2.8 million provided by operating activities and $0.4 million in proceeds from the issuance of common stock, partially offset by $2.7 million used for payments on property and equipment and other asset financing.

As of September 30, 2012, our cash and cash equivalents balance of $15.6 million consisted of $0.6 million in cash and $15.0 million in cash equivalents held in U.S. denominated money market funds. Although we did not hold short- or long-term investments as of September 30, 2012, our investment policy requires that our portfolio maintains a weighted average maturity of less than 12 months. Additionally, no maturities can extend beyond 24 months and concentrations with individual securities are limited. Investments must be rated at least A-1 / P-1 / F-1 by at least two Nationally Recognized Statistical Rating Organizations, and our investment policy is reviewed at least annually by our Audit Committee.

Although cash balances held at our foreign subsidiaries would be subject to U.S. taxes if repatriated, we have sufficient U.S. net operating losses to offset the liability associated with any such repatriation and foreign taxes due upon repatriation would not be significant.

Accounts receivable, net

Accounts receivable, net decreased to $3.8 million as of September 30, 2012 from $4.6 million as of December 31, 2011. The average number of days sales outstanding decreased to 21 days as of September 30, 2012 from 24 days as of December 31, 2011. The decrease in days sales outstanding was primarily due to an increase in customer payments received in advance of payment terms.

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Inventories

Inventories increased to $4.7 million as of September 30, 2012 from $4.1 million as of December 31, 2011. Inventory turnover decreased to 7.6 as of September 30, 2012 from 8.0 as of December 31, 2011, primarily due to decreased material costs. Inventory turnover is calculated based on annualized operating results and average inventory balances for the respective quarters.

Capital resources

Short-term line of credit

On December 21, 2010, we entered into a Loan and Security Agreement (the “Revolving Loan Agreement”) with Silicon Valley Bank (the “Bank”). The Revolving Loan Agreement provides for a secured working capital-based revolving line of credit (the “Revolving Line”) in an aggregate amount of up to the lesser of (i) $10.0 million, or (ii) 80% of eligible domestic accounts receivable and certain foreign accounts receivable. In addition, the Revolving Loan Agreement provides for non-formula advances of up to $10.0 million which may be made solely during the last five business days of any fiscal month or quarter and which must be repaid by the Company on or before the fifth business day after the applicable fiscal month or quarter end. Due to their repayment terms, non-formula advances do not provide the Company with usable liquidity.

The Revolving Loan Agreement contains customary affirmative and negative covenants as well as customary events of default. The occurrence of an event of default could result in the acceleration of the Company’s obligations under the Revolving Loan Agreement and an increase to the applicable interest rate, and would permit the Bank to exercise remedies with respect to its security interest. As of September 30, 2012, we were in compliance with all of the terms of the Revolving Loan Agreement.

As of September 30, 2012 and December 31, 2011, we had no outstanding borrowings under the Revolving Line.

Liquidity

As of September 30, 2012, we have no short- or long-term debt and our cash and cash equivalents balance of $15.6 million is highly liquid. We anticipate that our existing working capital, as well as funds available under our Revolving Line, will be adequate to fund our operating, investing and financing needs for the next twelve months. If necessary, management will pursue financing arrangements including the issuance of debt or equity securities or will reduce expenditures, in order to meet the Company’s cash requirements. There is no assurance that, if required, we will be able to raise additional capital or reduce discretionary spending to provide the required liquidity which, in turn, may have an adverse effect on our results of operations and financial position.

From time to time, we may evaluate acquisitions of businesses, products or technologies that complement our business. Any further transactions, if consummated, may consume a material portion of our working capital or require additional financing activities, including the issuance of equity securities that may result in dilution to existing shareholders.

Contractual Payment Obligations

Our contractual obligations for 2012 and beyond are included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the Securities and Exchange Commission on March 8, 2012. Our obligations for 2012 and beyond have not changed materially as of September 30, 2012.

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, results of operations, liquidity, capital expenditures or capital resources.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Interest Rate Risk

As of September 30, 2012, all of our cash equivalents were held in highly liquid money market accounts, accordingly, we do not have significant exposure to changes in interest rates.

Exchange Rate Risk

We are exposed to risks resulting from the fluctuations of foreign currencies, primarily those of Japan, Taiwan, Korea and the People's Republic of China. We sell our products to Original Equipment Manufacturers ("OEMs") that incorporate our products into other products that they sell outside of the U.S. While sales of our products to OEMs are denominated in U.S. dollars, the products sold by OEMs are denominated in foreign currencies. Accordingly, any strengthening of the U.S. dollar against these foreign currencies will increase the foreign currency price equivalent of our products, which could lead to a change in the competitive nature of these products in the marketplace.

In addition, a portion of our operating expenses, such as employee salaries and foreign income taxes, 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 will negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. We analyze our exposure to foreign currency fluctuations and may engage in financial hedging techniques in the future to attempt to minimize the effect of these potential fluctuations; however, foreign currency exchange rate fluctuations may adversely affect our financial results in the future.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Based on management’s evaluation (with the participation of our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”)), as of the end of the period covered by this report, our CEO and CFO have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the “Exchange Act”)) are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

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

Inherent Limitations on Effectiveness of Controls

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

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings.
For a discussion of legal proceedings, see “Note 11: Commitments and Contingencies” in the Notes to Condensed Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors.
Investing in our shares of common stock involves a high degree of risk, and investors should carefully consider the risks described below before making an investment decision. If any of the following risks occur, the market price of our shares of common stock could decline and investors could lose all or part of their investment. Additional risks that we currently believe are immaterial may also impair our business operations. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2011, including our consolidated financial statements and related notes, and our other filings made from time to time with the Securities and Exchange Commission.
Company Specific Risks
Our product strategy, which is targeted at markets demanding superior video and image quality, may not lead to new design wins or increased revenue in a timely manner or at all, which could materially adversely affect our results of operations and limit our ability to grow.
We have adopted a product strategy that focuses on our core competencies in pixel processing and delivering high levels of video and image quality. With this strategy, we continue to make further investments in the development of our ImageProcessor architecture for the digital projector market, with particular focus on adding increased performance and functionality. For the advanced television market, our strategy focuses on implementing our intellectual property (“IP”) to improve the video performance of our customers’ image processors through the use of our MotionEngine® advanced video co-processor integrated circuits. This strategy is designed to address the needs of the large-screen, high-resolution, high-quality segment of the television market. Such markets may not develop or may take longer to develop than we expect. We cannot assure you that the products we are developing will adequately address the demands of our target customers, or that we will be able to produce our new products at costs that enable us to price these products competitively.
Even if our product strategy is properly targeted, we cannot assure you that the products we are developing will lead to an increase in revenue from new design wins. To achieve design wins, we must design and deliver cost-effective, innovative and integrated semiconductors that overcome the significant costs associated with qualifying a new supplier and which make developers reluctant to change component sources. Additionally, potential developers may be unwilling to select our products due to concerns over our financial strength. Further, design wins do not necessarily result in developers ordering large volumes of our products. Developers can choose at any time to discontinue using our products in their designs or product development efforts. A design win is not a binding commitment by a developer to purchase our products, but rather a decision by a developer to use our products in its design process. Even if our products are chosen to be incorporated into a developer’s products, we may still not realize significant revenue from the developer if its products are not commercially successful or it chooses to qualify, or incorporate the products, of a second source. Additionally, even if our product strategy is successful at achieving design wins and increasing our revenue, we may continue to incur operating losses due to the significant research and development costs that are required to develop competitive products for the advanced television and digital projection markets.
We may fail to retain or attract the specialized technical and management personnel required to successfully operate our business.
Our success depends on the continued services of our executive officers and other key management, engineering, and sales and marketing personnel and on our ability to continue to attract, retain and motivate qualified personnel. Competition for skilled engineers and management personnel is intense within our industry, and we may not be successful in hiring and retaining qualified individuals. For example, we have experienced, and may continue to experience, difficulty and increased compensation expense in order to hire and retain qualified engineering personnel

in our Shanghai design center. The loss of, or inability to hire, key personnel could limit our ability to develop new products and adapt existing products to our customers’ requirements, and may result in lost sales and a diversion of management resources.

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We have significantly less financial resources than most of our competitors which limits our ability to implement new products or enhancements to our current products and may require us to implement future restructuring plans, which could adversely affect our future sales and financial condition.

Financial resource constraints could limit our ability to execute our product strategy or require us to implement restructuring plans, particularly if we are unable to generate cash from operations or obtain additional sources of financing. Any future restructuring actions may slow our development of new or enhanced products by limiting our research and development and engineering activities. Our cash balances are also lower than those of our competitors, which may limit our ability to develop competitive new products on a timely basis. If we are unable to successfully introduce new or enhanced products, our sales and financial condition will be adversely affected.

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

We have incurred operating losses since 2004. If and when we achieve profitability depends upon a number of factors, including our ability to develop and market innovative products, accurately estimate inventory needs, contract effectively for manufacturing capacity and maintain sufficient funds to finance our activities. We cannot assure you that we will ever achieve profitability. If we are not profitable in the future, we may be unable to continue our operations.

A significant amount of our revenue comes from a limited number of customers and distributors and from time to time we may enter into exclusive deals with customers, exposing us to increased credit risk and subjecting our cash flow to the risk that any of our customers or distributors could decrease or cancel its orders.

The display manufacturing market is highly concentrated and we are, and will continue to be, dependent on a limited number of customers and distributors for a substantial portion of our revenue. Sales to our top distributor represented 50%, 53% and 44% of revenue for the nine month period ended September 30, 2012 and the years ended December 31, 2011 and 2010, respectively. Revenue attributable to our top five end customers represented 54%, 51% and 58% of revenue for the nine month period ended September 30, 2012 and the years ended December 31, 2011 and 2010, respectively. As of September 30, 2012, we had four accounts that each represented 10% or more of accounts receivable. As of September 30, 2011, we had three accounts that each represented 10% or more of accounts receivable. All of the orders included in our backlog are cancelable. 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. Further, the concentration of our accounts receivable with a limited number of customers increases our credit risk. The failure of these customers to pay their balances, or any customer to pay future outstanding balances, would result in an operating expense and reduce our cash flows.

We may not be able to borrow funds under our credit facility or secure future financing.

In December 2010, we entered into a Loan and Security Agreement with Silicon Valley Bank to provide a secured, working capital-based, revolving line of credit. We view this line of credit as a source of available liquidity to fund fluctuations in our working capital requirements. For example, if we experience an increase in order activity from our customers, our cash balance may decrease due to the need to purchase inventories to fulfill those orders. If this occurs, we may need to draw on this facility in order to maintain our liquidity.

This facility contains various conditions, covenants and representations with which we must be in compliance in order to borrow funds. We cannot assure you that we will be in compliance with these conditions, covenants and representations in the future when we may need to borrow funds under this facility. In addition, this facility expires on December 21, 2012, after which time we may need to secure new financing to continue funding fluctuations in our working capital requirements. We cannot assure you that we will be able to secure new financing, or financing on terms that are acceptable to us.

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Part of our business involves licensing our intellectual property, a strategy that increases business risk and volatility.
We have licensed certain of our intellectual properties to third parties and may seek to enter into additional license arrangements in the future. We cannot assure you, however, that others will be interested in licensing our intellectual property on commercially favorable terms or at all. We also cannot ensure that licensees will honor agreed-upon market restrictions, not infringe upon or misappropriate our intellectual property or maintain the confidentiality of our proprietary information.
IP license agreements are complex and earning revenue under these agreements depends upon many factors including completion of milestones, allocation of values to delivered items and customer acceptances. Many of these factors require significant judgments. Because of its high margin, our licensing revenue can have a disproportionate impact on gross profit and profitability. Also, generating revenue from these arrangements is a lengthy and complex process that may last beyond the period in which efforts begin and, once an agreement is in place, the timing of revenue recognition may depend on customer acceptance of deliverables, achievement of milestones, our ability to track and report progress on contracts, customer commercialization of the licensed technology and other factors. The accounting rules associated with recognizing revenue from these transactions are complex and subject to interpretation. Due to these factors, the amount of license revenue recognized in any period may differ significantly from our expectations.
Our net operating loss carryforwards may be limited or they may expire before utilization.
As of December 31, 2011, we had federal and state net operating loss carryforwards of approximately $181.6 million and $38.8 million, respectively, which expire between 2012 and 2031. These net operating loss carryforwards may be used to offset future taxable income and thereby reduce our income taxes otherwise payable. However, we cannot assure you that we will have taxable income in the future before all or a portion of these net operating loss carryforwards expire. Additionally, our federal net operating losses may be limited by Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), which imposes an annual limit on the ability of a corporation that undergoes an "ownership change" to use its net operating loss carryforwards to reduce its tax liability. An ownership change is generally defined as a greater than 50% point increase in equity ownership by 5% shareholders in any three-year period. In the event of certain changes in our shareholder base, we may at some time in the future experience an "ownership change" and the use of our federal net operating loss carryforwards may be limited.
We face a number of risks as a result of the concentration of our operations and customers in Asia.
Almost all of our customers are located in Japan, the People's Republic of China ("PRC"), Korea, or Taiwan. Sales outside the U.S. accounted for approximately 87% of revenue for the nine month period ended September 30, 2012 and 96% of revenue for the years ended December 31, 2011 and 2010, respectively. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenue in future periods. In addition, customers who incorporate our products into their products sell a substantial portion of their products outside of the U.S. All of our products are also manufactured outside of the U.S.; most of our current manufacturers are located in the PRC, Taiwan, or Singapore. Furthermore, most of our employees are located in the PRC, Japan and Taiwan. Our Asian operations require significant management attention and resources, and we are subject to many risks associated with operations in Asia, including, but not limited to:

- difficulties in managing international distributors and manufacturers due to varying time zones, languages and business customs;
- compliance with U.S. laws affecting operations outside of the U.S., such as the Foreign Corrupt Practices Act;
- reduced or limited protection of our IP, particularly in software, which is more prone to design piracy;
- difficulties in collecting outstanding accounts receivable balances;
- changes in tax rates, tax laws and the interpretation of those laws;
- difficulties regarding timing and availability of export and import licenses;
- ensuring that we obtain complete and accurate information from our Asian operations to make proper disclosures in the United States;
- political and economic instability;
- 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 or our customers’ sales of their own products;

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- outbreaks of health epidemics in the PRC or other parts of Asia;
- imposition of new tariffs, quotas, trade barriers and similar trade restrictions on our sales;
- varying employment and labor laws; and
- greater vulnerability to infrastructure and labor disruptions than in established markets.

Any of these factors could require a disproportionate share of management's attention, result in increased costs or decreased revenues, and could materially affect our product sales, financial condition and results of operations.

Our operations in Asia expose us to heightened risks due to natural disasters.

The risk of natural disasters in the Pacific Rim region, such as the March 2011 earthquake and tsunami in Japan, is significant due to the proximity of major earthquake fault lines in the area. Natural disasters in countries where our manufacturers or customers are located could result in disruption of our manufacturers' and customers' operations, resulting in significant delays in shipment of, or significant reductions in orders for, our products. There can be no assurance that we can locate additional manufacturing capacity or markets on favorable terms, or find new customers, in a timely manner, if at all. Natural disasters in this region could also result in:

- reduced end user demand due to the economic impact of any natural disaster;
- a disruption to the global supply chain for products manufactured in areas affected by natural disasters that are included in products purchased either by us or by our customers;
- an increase in the cost of products that we purchase due to reduced supply; and
- other unforeseen impacts as a result of the uncertainty resulting from a natural disaster.

For example, the 2011 flooding in Thailand limited the availability of certain component parts that are used in the production of our customers' products which reduced their production capacity and the demand for our products during the first quarter of 2012.

We face additional risks associated with our operations in the PRC.

We have, and expect to continue to have significant operations in the PRC. The economy of the PRC differs from the economies of many countries in important respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation, foreign currency flows and balance of payments position, among others. We cannot be assured that the PRC's economic policies will be consistent or effective and our results of operations and financial position may be harmed by changes in the PRC's political, economic or social conditions.

Additionally, our Chinese subsidiary is considered a foreign-invested enterprise and is subject to laws and regulations applicable to foreign investment in the PRC and, in particular, laws applicable to foreign-invested enterprises. While the overall effect of legislation over the past two decades has significantly enhanced the protections afforded to various foreign investments in the PRC, the PRC has not developed a fully integrated legal system, and recently enacted laws and regulations may not sufficiently cover all aspects of economic activities in the PRC. Because these laws and regulations are relatively new, and published court decisions are limited and nonbinding in nature, the interpretation and enforcement of these laws and regulations involve uncertainties. In addition, the PRC legal system is based in part on government policies and internal rules, some of which are not published on a timely basis or at all, which may have a retroactive effect. As a result, we may not be aware of our violation of these policies and rules until after the violation occurs. Any administrative and court proceedings in the PRC may be protracted, resulting in substantial costs and diversion of resources and management attention. However, since PRC administrative and court authorities have significant discretion in interpreting and implementing statutory and contractual terms, it may be more difficult to evaluate the outcome of administrative and court proceedings. These uncertainties may also impede our ability to enforce the contracts entered into by our PRC subsidiary and could materially and adversely affect our business and results of operations.

Our international operations expose us to risks resulting from the fluctuations of foreign currencies.

We are exposed to risks resulting from the fluctuations of foreign currencies, primarily those of Japan, Taiwan, Korea and the PRC. We sell our products to OEMs that incorporate our products into other products that they sell outside of the U.S. While sales of our products to OEMs are denominated in U.S. dollars, the products sold by OEMs are denominated in foreign currencies. Accordingly, any strengthening of the U.S. dollar against these foreign currencies will increase the foreign currency price equivalent of our products, which could lead to a change in the competitive nature of these products in the marketplace. This in turn could lead to a reduction in revenue.

In addition, a portion of our operating expenses, such as employee salaries and foreign income taxes, 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 will negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars.

We may engage in financial hedging techniques in the future as part of a strategy to address potential foreign currency exchange rate fluctuations. These hedging techniques, however, may not be successful at reducing our exposure to foreign currency exchange rate fluctuations and may increase costs and administrative complexity.

As we have limited insurance coverage, any incurred liability resulting from uncovered claims could adversely affect our financial condition and results of operations.

Our insurance policies may not be adequate to fully offset losses from covered incidents, and we do not have coverage for certain losses. For example, we do not have earthquake insurance related to our Asian operations because adequate coverage is not offered at economically justifiable rates. If our insurance coverage is inadequate to protect us against catastrophic losses, any uncovered losses could adversely affect our financial condition and results of operations.

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

The estimates we use for our advance orders from contract manufacturers are based, in part, on reports of inventory levels and production forecasts from our distributors and integrators, which act as intermediaries between us and the companies using our products. This process requires us to make numerous assumptions concerning demand and to rely on the accuracy of the reports and forecasts of our distributors and integrators, each of which may introduce error into our estimates of inventory requirements. Our failure to manage this challenge could result in excess inventory or inventory shortages that could materially impact our operating results or limit the ability of companies using our semiconductors to deliver their products. For example, we overestimated demand for certain of our products which led to significant charges for obsolete inventory in 2010 and 2009. On the other hand, if we underestimate demand, we would forego revenue opportunities, lose market share and damage our customer relationships.

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

If we fail to effectively manage any future internal growth, our operating expenses may increase more rapidly than our revenue, adversely affecting our financial condition and results of operations. To manage any future growth effectively in a rapidly evolving market, we must be able to maintain and improve our operational and financial systems, train and manage our employee base and attract and retain qualified personnel with relevant experience. We could spend substantial amounts of time and money in connection with expansion efforts for which we may not realize any profit. Our systems, procedures, controls or financial resources may not be adequate to support our operations and we may not be able to grow quickly enough to exploit potential market opportunities. In addition, we may not be able to successfully integrate the businesses, products, technologies or personnel of any entity that we might acquire in the future, and any failure to do so could disrupt our business and seriously harm our financial condition.

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

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

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

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

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

We rely upon certain critical information systems for the operation of our business, and the failure of any critical information system, may result in serious harm to our business.

We maintain and rely upon certain critical information systems for the effective operation of our business. These information systems include telecommunications, the Internet, our corporate intranet, various computer hardware and software applications, network communications and e-mail. These information systems are subject to attacks, failures and access denials from a number of potential sources including viruses, destructive or inadequate code, power failures, and physical damage to computers, communication lines and networking equipment. To the extent that these information systems are under our control, we have implemented security procedures, such as virus protection software and emergency recovery processes, to address the outlined risks. Security procedures for information systems cannot be guaranteed to be failsafe and our inability to use or access these information systems at critical times could compromise the timely and efficient operation of our business. Additionally, any compromise of our information security could result in the unauthorized publication of our confidential business or proprietary information, cause an interruption in our operations, result in the unauthorized release of customer or employee data, result in a violation of privacy or other laws, or expose us to a risk of litigation or damage our reputation, any or all of which could harm our business and operating results.

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

We are subject to numerous environmental laws and regulations. Compliance with current or future environmental laws and regulations could require us to incur substantial expenses which could harm our business, financial condition and results of operations. We have worked, and will continue to work, with our suppliers and customers to ensure that our products are compliant with enacted laws and regulations. Failure by us or our contract manufacturers to comply with such legislation could result in customers refusing to purchase our products and could subject us to significant monetary penalties in connection with a violation, either of which would have a material adverse effect on our business, financial condition and results of operations.

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Company Risks Related to the Semiconductor Industry and Our Markets

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

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

Additionally, customers could seek damages from us for their losses and shipments of defective products may harm our reputation with our customers. We have experienced field failures of our semiconductors in certain customer applications that required us to institute additional testing. As a result of these field failures, we have incurred warranty costs due to customers returning potentially affected products and have experienced reductions in revenues due to delays in production. Our customers have also experienced delays in receiving product shipments from us that resulted in the loss of revenue and profits. In 2010, for example, we incurred higher than expected yield losses due to defective third party IP incorporated into certain of our products, which resulted in higher direct material cost and a temporary inability to meet our customers' requested demand. Although we were able to resolve the issue without incurring material losses and have implemented additional processes to control this type of risk, similar issues may occur again in the future. Additionally, shipments of defective products could cause us to lose customers or to incur significant replacement costs, either of which would harm our business. Any defects, errors or bugs could also interrupt or delay sales of our new products to our customers, which would adversely affect our financial results.

The development of new products is extremely complex and we may be unable to develop our new products in a timely manner which could result in a failure to obtain new design wins and/or maintain our current revenue levels.

In addition to the inherent difficulty of designing complex integrated circuits, product development delays may result from:

- difficulties in hiring and retaining necessary technical personnel;
- difficulties in reallocating engineering resources and overcoming resource limitations;
- difficulties with contract manufacturers;
- changes to product specifications and customer requirements;
- changes to market or competitive product requirements; and
- unanticipated engineering complexities.

If we are not successful in the timely development of new products, our financial results will be adversely affected.

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

We compete with specialized and diversified electronics and semiconductor companies that offer display processors or scaling components. Some of these include Actions Microelectronics Co., Ltd., CSR plc, i-Chips Technologies Inc., Intersil Corporation, MediaTek Inc., MStar Semiconductor, Novatech Co., Ltd. Inc., Realtek Semiconductor Corp., Renesas Electronics America, Sigma Designs, Inc., Silicon Image, Inc., STMicroelectronics N.V., Sunplus Technology Co., Ltd., and other companies. Potential and current competitors may include diversified semiconductor manufacturers and the semiconductor divisions or affiliates of some of our customers, including LG Electronics, Inc., Matsushita Electric Industrial Co., Ltd., Mitsubishi Digital Electronics America, Inc., NEC Corporation, NVIDIA Corporation, QUALCOMM Incorporated, 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.

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Many of our competitors have longer operating histories and greater resources to support development and marketing efforts than we do. Some of our competitors operate their own fabrication facilities. These competitors may be able to react more quickly and devote more resources to efforts that compete directly with our own. Our current or potential customers have developed, and may continue to develop, their own proprietary technologies and become our competitors. Increased competition from both competitors and our customers' internal development efforts could harm our business, financial condition and results of operations by, for example, increasing pressure on our profit margin or causing us to lose sales opportunities. For example, frame rate conversion technology similar to that used in our line of MotionEngine® advanced video co-processors continues to be integrated into the system-on-chip ("SoC") products of our competitors, including in television products with refresh rates as high as 240hz. We cannot assure you that we can compete successfully against current or potential competitors.

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

The markets in which we compete or seek to compete are subject to rapid technological change and miniaturization capabilities, frequent new product introductions, changing customer requirements for new products and features and evolving industry standards. The introduction of new technologies and emergence of new industry standards could render our products less desirable or obsolete, which could harm our business and significantly decrease our revenue. Examples of changing industry standards include the growing use of broadband to deliver video content, increased display resolution and size, faster screen refresh rates, video capability such as high definition and 3D, the proliferation of new display devices and the drive to network display devices together. Our failure to predict market needs accurately or to timely develop new competitively priced products or product enhancements that incorporate new industry standards and technologies, including integrated circuits with increasing levels of integration and new features, using smaller geometry process technologies, may harm market acceptance and sales of our products.

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. Additionally, if the technology used by our customers becomes less competitive due to cost, customer preferences or other factors relative to alternative technologies, sales of our products could decline.

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

We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. We rely on a limited number of foundries and assembly and test vendors to produce all of our wafers and for completion of finished products. Our wafers are not fabricated at more than one foundry at any given time and our wafers typically are designed to be fabricated in a specific process at only one foundry. Sole sourcing each product increases our dependence on our suppliers. We have limited control over delivery schedules, quality assurance, manufacturing yields, potential errors in manufacturing and production costs. We do not have long-term supply contracts with our third-party manufacturers, so they are not obligated to supply us with products for any specific period of time, quantity or price, except as may be provided in a particular purchase order. Our suppliers can increase the prices of the products we purchase from them with little notice, which may cause us to increase the prices to our customers and harm our competitiveness. Because our requirements represent only a small portion of the total production capacity of our contract manufacturers, they could reallocate capacity to other customers during periods of high demand for our products, as they have done in the past. We expect this may occur again in the future.

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

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

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

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

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

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

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

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

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. Additionally, the transition to smaller geometry process technologies continues to significantly increase the cost and complexity of new product development, particularly with regards to tooling, software tools, third party IP and engineering resources. 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, if at all. 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.

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Furthermore, we have entered into and may in the future enter into, co-development agreements that do not guarantee future sales volumes and limit our ability to sell the developed products to other customers. The exclusive nature of these development agreements increases our dependence on individual customers, particularly since we are limited in the number of products we are able to develop at any one time.

If actual sales volumes for a particular product are substantially less than originally anticipated, we may experience large write-offs of capitalized license fees, software development tools, product masks, inventories or other capitalized or deferred product-related costs, or increased amortization of non-cancelable prepaid royalties, any of which would negatively affect our operating results. For example, we overestimated demand for certain of our products which led to significant charges for obsolete inventory in 2010 and 2009.

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

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

The competitiveness and viability of our products could be harmed if necessary licenses of third-party technology are not available to us on terms that are acceptable to us or at all.

We license technology from independent third parties that is incorporated into our products or product enhancements. Future products or product enhancements may require additional third-party licenses that may not be available to us on terms that are acceptable to us or at all. 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 code. We provide the computer programming code for our software to customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to help protect our proprietary technologies. We hold 117 patents and have 29 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 patent, 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. We may incur significant costs to stop others from infringing our patents. In addition, it is possible that existing or future patents may be invalidated, diluted, circumvented, challenged or licensed to others.

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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 intellectual property rights. In recent years, there has been significant litigation in the United States and in other jurisdictions involving patents and other intellectual property rights. This litigation is particularly prevalent in the semiconductor industry, in which a number of companies aggressively use their patent portfolios to bring infringement claims. In recent years, there has been an increase in the filing of so-called “nuisance suits,” alleging infringement of intellectual property rights. These claims may be asserted initially or as counterclaims in response to claims made by a company alleging infringement of intellectual property rights. These suits pressure defendants into entering settlement arrangements to quickly dispose of such suits, regardless of merit. We may also face claims brought by companies that are organized solely to hold and enforce patents. In addition, we may be required to indemnify our customers against IP claims related to their usage of our products.

IP claims could subject us to significant liability for damages and invalidate our proprietary rights. Responding to such claims, regardless of their merit, can be time-consuming, result in costly litigation, divert management’s attention and resources and cause us to incur significant expenses. As each claim is evaluated, we may consider the desirability of entering into settlement or licensing agreements. No assurance can be given that settlements will occur or that licenses can be obtained on acceptable terms or that litigation will not occur. In the event there is a temporary or permanent injunction entered prohibiting us from marketing or selling certain of our products, or a successful claim of infringement against us requiring us to pay damages or royalties to a third-party and we fail to develop or license a substitute technology, our business, results of operations or financial condition could be materially adversely affected.

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 terms that are acceptable to us 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.

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

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

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

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

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Other Risks

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

Slow economic activity, increased unemployment, decreased business and consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns have contributed to and continue to contribute to a challenging economic environment. As a result of these conditions and uncertainties, our manufacturers, vendors and customers might experience deterioration of their businesses, cash flow shortages and difficulty obtaining financing which could result in interruptions or delays in the performance of any contracts, reductions and delays in customer purchases, delays in or the inability of customers to obtain financing to purchase our products, and bankruptcy of customers. Furthermore, the constraints in the capital and credit markets, including as a result of the recent crisis involving the Euro and European sovereign debt, may limit the ability of our customers to meet their liquidity needs, which could result in an impairment of their ability to make timely payments to us and reduce their demand for our products, adversely impacting our results of operations and cash flows. This environment has also made it difficult for us to accurately forecast and plan future business activities.

The interest of our current or potential significant shareholders may conflict with other shareholders and they may attempt to effect changes at the Company or acquire control over the Company, which could adversely affect the Company’s results of operations and financial condition.

Shareholders of the Company may from time to time engage in proxy solicitations, advance shareholder proposals, acquire control over the Company or otherwise attempt to effect changes, including by directly voting their shares on shareholder proposals. Campaigns by shareholders to effect changes at publicly traded companies are sometimes led by investors seeking to increase short-term shareholder value through actions such as financial restructuring, increased debt, special dividends, stock repurchases or sales of assets or the entire company. Responding to proxy contests and other actions by activist shareholders can be costly and time-consuming, disrupting the Company’s operations and diverting the attention of the Company’s Board of Directors and senior management from the pursuit of business strategies. Additionally, uncertainty over the Company’s direction and leadership may negatively impact the Company’s relationship with its customers and make it more difficult to attract and retain qualified personnel and business partners. As a result, shareholder campaigns could adversely affect the Company’s results of operations and financial condition.

We have entered into a standstill agreement with Becker Drapkin Management L.P. and related entities (“Becker Drapkin”) included in a 13(d) 10% group.

We have entered into a standstill agreement with Becker Drapkin that required us to nominate two directors to our board of directors that have been selected by Becker Drapkin. The standstill agreement also requires Becker Drapkin to vote with the board on certain matters and prevents Becker Drapkin from taking certain actions, including participating in any sale transaction or tender offer that is not approved by our board of directors. There is no restriction, however, on Becker Drapkin’s ability to vote against a sale transaction that is approved by our board of directors. All of these provisions could make it more difficult, and deter a third party from making an offer to purchase the Company.

Upon expiration of the term of the standstill agreement, there will no longer be restrictions on Becker Drapkin’s ability to buy additional shares, vote or participate in sale transactions or tender offers. As a result, Becker Drapkin will have the ability to exert significant influence on our management and operations, and matters requiring approval of its stockholders, including the approval of significant corporate transactions, such as a merger or other sale of the Company or its assets. In August 2012, we entered into an amendment to the standstill agreement with Becker Drapkin that grants Becker Drapkin the right to acquire additional shares of our common stock on or before November 30, 2012.

In addition, the acquisition of additional shares or sale of shares by Becker Drapkin could trigger an “ownership change” under Section 382 of the Code and result in a limitation in our ability to use our net operating loss carryforwards, pursuant to Section 382 of the Code.

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Future sales of our equity could result in significant dilution to our existing shareholders and depress the market price of our common stock.

We may need to seek additional capital from time to time. If this financing is obtained through the issuance of equity securities, debt convertible into equity securities, options or warrants to acquire equity securities or similar instruments or securities, our existing shareholders will experience dilution in their ownership percentage upon the issuance, conversion or exercise of such securities and such dilution could be significant. For example, in May 2011, we issued 4.2 million shares of our common stock in an underwritten registered offering. New equity securities issued by us could have rights, preferences or privileges senior to those of our common stock.

In addition, any such issuance by us or sales of our securities by our security holders, or the perception that such issuances or sales could occur, could negatively impact the market price of our securities. For example, a number of shareholders own significant blocks of our common stock. If one or more of these shareholders were to sell large portions of their holdings in a relatively short time, for liquidity or other reasons, the prevailing market price of our common stock could be negatively affected. This could result in further potential dilution to our existing shareholders and the impairment of our ability to raise capital through the sale of equity, debt or other securities.

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

Our stock price and the stock prices of technology companies similar to Pixelworks have been highly volatile. The price of our common stock may decline and the value of your investment may be reduced regardless of our performance.

The daily trading volume of our common stock has historically been relatively low. As a result, our shareholders may be unable to sell significant quantities of common stock in the public trading markets without a significant reduction in the price of our common shares. Additionally, 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. Other factors that could negatively impact our stock price include:

- actual or anticipated fluctuations in our operating results;
- changes in expectations as to our future financial performance;
- changes in financial estimates of securities analysts;
- announcements by us or our competitors of technological innovations, design wins, contracts, standards, acquisitions or divestitures;
- the operating and stock price performance of other comparable companies;
- issuances or proposed issuances of equity, debt or other securities by us, or sales of securities by our security holders; and
- changes in market valuations of other technology companies.

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

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

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

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In addition to the minimum $1.00 per share requirement, NASDAQ Global Market also requires satisfaction of one of the following in addition to certain other requirements: (i) a minimum of $50.0 million in total asset value and $50.0 million in revenues (in the latest fiscal year or in two of the last three fiscal years), (ii) a minimum of $50.0 million in market value of listed securities, or (iii) a minimum of $10.0 million in stockholders' equity. We have, and expect to continue to have, a total asset value of less than $50.0 million and as recently as December 31, 2008, our shareholders' equity was below $10.0 million. In the future, we may be unable to meet these continued listing requirements and our stock could become subject to delisting.

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

The anti-takeover provisions of Oregon law and in our articles of incorporation could adversely affect the rights of the holders of our common stock, including 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:

- our board of directors is divided into three classes serving staggered terms, which would make it more difficult for a group of shareholders to quickly replace a majority of directors;
- 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 be removed only for cause and at a meeting of shareholders called expressly for that purpose, by the vote of 75 percent of the votes then entitled to be cast for the election of directors;
- our board of directors may alter our bylaws without obtaining shareholder approval; and shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting;
- Oregon law permits our board to consider other factors beyond stockholder value in evaluating any acquisition offer (so-called "expanded constituency" provisions); and
- a supermajority (67%) vote of shareholders is required to approve certain fundamental transactions.

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Item 6. Exhibits.

10.1	Amendment No. 1 dated August 9, 2012 to the Agreement dated February 8. 2012 by and among Pixelworks, Inc., Steven R. Becker, Matthew A. Drapkin, BC Advisors, LLC, Becker Drapkin Management, L.P., Becker Drapkin Partners (QP), L.P., Becker Drapkin Partners, L.P., BD Partners IV, L.P., and Bradley Shisler (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 9, 2012).
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.

* Furnished, not filed.

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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: November 2, 2012	/s/ Steven L. Moore Steven L. Moore Vice President, Chief Financial Officer, Secretary and Treasurer