PIXELWORKS, INC
Form 10-K
March 16, 2009

Table of Contents

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-K**

[ x ] ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

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**<br>(State or other jurisdiction of incorporation or organization) | **91-1761992**<br>(I.R.S. Employer Identification No.) |
|---|---|

| **16760 SW Upper Boones Ferry Road, Suite 101**<br>(Address of principal executive offices) | **97224**<br>(Zip Code) |
|---|---|

**503-601-4545**
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock** | **NASDAQ Global Market** |

Securities registered pursuant to Section 12(g) of the Act:
**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes _____ No __X__

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes _____ No __X__

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or Section 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

| 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 Act).

Yes _____ No __X__

Aggregate market value of voting Common Stock held by non-affiliates of the registrant at June 30, 2008: $20,207,718. For purposes of this calculation, executive officers and directors are considered affiliates.

Number of shares of Common Stock outstanding as of February 28, 2009: 13,288,690.

**Documents Incorporated by Reference**

Portions of the registrant s definitive proxy statement relating to its 2009 Annual Meeting of Shareholders, to be filed not later than 120 days after the close of the 2008 fiscal year are incorporated by reference into Part I and Part III of this Annual Report on Form 10-K.

---

**PIXELWORKS, INC.**
**FORM 10-K**
**FOR THE YEAR ENDED DECEMBER 31, 2008**

**TABLE OF CONTENTS**


**PART I**

| | | |
|---|---|---|
| Item 1. | Business. | 1 |
| Item 1A. | Risk Factors. | 11 |
| Item 1B. | Unresolved Staff Comments. | 26 |
| Item 2. | Properties. | 27 |
| Item 3. | Legal Proceedings. | 27 |
| Item 4. | Submission of Matters to a Vote of Security Holders. | 27 |

**PART II**

| | | |
|---|---|---|
| Item 5. | Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities. | 28 |
| Item 6. | Selected Financial Data. | 31 |
| Item 7. | Management s Discussion and Analysis of Financial Condition and Results of Operation. | 32 |
| Item 7A. | Quantitative and Qualitative Disclosures About Market Risk. | 46 |
| Item 8. | Financial Statements and Supplementary Data. | 47 |
| Item 9. | Changes in and Disagreements With Accountants on Accounting and Financial Disclosure. | 78 |
| Item 9A. | Controls and Procedures. | 78 |
| Item 9B. | Other Information. | 80 |

**PART III**

| | | |
|---|---|---|
| Item 10. | Director, Executive Officers and Corporate Governance. | 80 |
| Item 11. | Executive Compensation. | 80 |
| Item 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters. | 80 |
| Item 13. | Certain Relationships and Related Transactions, and Director Independence. | 80 |
| Item 14. | Principal Accounting Fees and Services. | 80 |

**PART IV**

| | | |
|---|---|---|
| Item 15. | Exhibits, Financial Statement Schedules. | 80 |

**SIGNATURES**

EX-23
EX-31.1
EX-31.2
EX-32.1
EX-32.2

Table of Contents

## Forward-looking Statements

*This Annual Report on Form 10-K, including the Management s Discussion and Analysis of Financial Condition and Results of Operation in Part II, Item 7, contains forward-looking statements that are based on current expectations, estimates, beliefs, assumptions and projections about our business. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. Actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors. Such factors include, but are not limited to, the global economic crisis, adverse economic conditions in the specific markets for our products, lack of acceptance of new products, increased competition, failure to design, develop and manufacture new products, lack of success in technological advancements, unexpected changes in the demand for our products and services, the inability to successfully manage inventory pricing pressures, failure to reduce costs or improve operating efficiencies, changes to and compliance with international laws and regulations, currency fluctuations, our ability to attract, hire and retain key and qualified employees, and other risks identified in the risk factors contained in Part I, Item 1A of this Annual Report on Form 10-K. 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 Annual Report on Form 10-K. 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 Annual Report on Form 10-K, the Company, Pixelworks, we, us and our refer to Pixelworks, Inc., an Oregon corporation, and, where appropriate, its subsidiaries.*

## PART I

### Item 1. Business.

### Overview

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications. Our solutions enable manufacturers of digital display and projection devices, such as large-screen liquid crystal displays ( LCDs ) and digital front projectors, to differentiate their products with a consistently high level of video quality, regardless of the content s source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation. Pixelworks flexible design architecture enables our technology to produce outstanding image quality in our customers display and projection products with a range of integrated circuit ( IC ) and software solutions. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

Over the course of the last several years, the display and projection industries have moved rapidly from analog technology, which utilizes waveform signals, to a new generation of digital technologies that utilize a grid of thousands of tiny picture elements, or pixels. Digital display technology is rapidly evolving to incorporate higher pixel counts and faster rates of screen refresh, both of which contribute to a sharper, clearer image. Accordingly, the video image processors that drive newer displays have had to increase their capabilities as well to keep pace with the ever growing needs for greater resolution, size and speed that digital technology affords.

Pixelworks has an array of proprietary technologies and advanced designs to address the requirements of diverse high-end digital video devices, from digital projectors to large screen LCDs. Our products range from single-purpose

ICs, to system-on-chip ( SoC ) ICs that integrate microprocessor, memory and image processing functions. Additionally, we provide full solutions, including a software development environment and

operating system, which enable our customers to more quickly develop and customize their display products, thus reducing their time to market and enabling them to incorporate differentiated features and functions. During 2008 we focused on developing products that provide additional functionality and utilize more advanced processes in order to improve performance and lower product costs. We continually seek to expand our technology portfolio through internal developments, co-developments with business partners and evaluation of acquisition opportunities.

We have adopted a product strategy that leverages our core competencies in video processing to address the evolving needs of the advanced flat panel display, digital projection and other markets that require superior image quality. We focus our product investments on developing video enhancement solutions for these markets, with particular focus on adding increased performance and functionality. Additionally, we look for ways to leverage our research and development investment into products that address other high-value markets where our innovative proprietary technology provides differentiation for us and our customers.

**Digital Video Technology Trends**

The number and variety of digital video applications is increasing rapidly, and video is expanding to play a pervasive role across many aspects of business and personal lifestyle. Digital video content is being delivered from an increasing array of sources of varying quality on Blu-ray DVDs, over the air, via cable and satellite, across the Internet and on cell phones. Consumers are creating video, sharing it with others and viewing it on an increasing variety of form factors from handheld devices to large screen displays.

The sources and quality of video content range from very high-resolution programming produced by network or movie studios to very poor quality clips posted from a cell phone to the Internet. At the same time, the consumer expectation for ever higher quality video continues to rise with ongoing transitions to higher display resolutions. These trends place new demands on video signal and pixel processing technology to enable display and projection devices to provide the best viewing experience possible across multiple display formats. For example, content created for one type of display device, such as a PC, must be scaled up or down to play back clearly on a different device, such as a television. On larger, higher-resolution TV screens, image quality deteriorates significantly, and must be compensated for with video processing technology that restores or even creates higher video quality.

The latest generations of advanced digital display devices enhance image performance in a number of ways, chief among them being increasing the display resolution and increasing the number of times per second the image is refreshed. Premium displays currently feature full HD resolutions of 1920 columns by 1080 rows of pixels progressively scanned ( 1080p ), and measure from 37 inches or more diagonally. In addition to the need for image enhancement, various applications, such as digital signage, Internet-enabled televisions and connected classroom environments, are creating a need for new networking capabilities that can enable the sharing of video across display devices and display environments.

Pixelworks focuses on providing image optimization and networked display capabilities for the advanced flat panel display, digital projection and other markets requiring high quality video, where continual innovation is reshaping how business users and consumers utilize digital video content for information and entertainment.

***Large-Screen Flat Panel Display Market***

The market for flat panel displays has exploded over the past 10 years and is now worth $100 billion annually, according to the display research firm, DisplaySearch. Key drivers of the flat panel display industry are consumer applications, such as PC monitors and digital televisions. Increasingly, commercial applications such as public-space advertising, a form of digital signage, are also contributing to the growth of the flat panel market and the drive to improve image and video quality of the panels themselves.

Flat panel display technologies include LCD, plasma display panels ( PDPs ), rear-projection using LCDs, digital micro-mirror devices ( DMDs ), and newer technologies, such as liquid crystal on silicon ( LCoS ) and organic light emitting diodes ( OLED ). Within flat panel displays, LCD and plasma have emerged as the preferred digital display technologies, with LCD leading the market in growth.

**Table of Contents**

Digital TVs are a leading application for flat panel displays, and the development of high-resolution, flat panel digital technology has transformed the television market, as consumers have welcomed sharper and more lifelike images on larger and thinner screens. Shipments of LCD TVs are expected to grow from 79.3 million units in 2007 to 119.9 million units in 2009, according to display industry research firm DisplaySearch.

A large consumer market has pressured flat panel manufacturers to continually improve the quality of their displays, and as a result LCDs and other flat panel displays continue to increase in resolution and size. 1080p resolution is now the high-end standard, and larger flat panel displays are also shifting rapidly from refresh rates of 50/60Hz to faster rates of 100/120Hz, and even 200/240Hz.

The shift to large, high-resolution flat panel displays combined with the transition to 1080p content and 120Hz refresh rates is driving the need for high performance processor solutions to meet the enhanced video quality requirements of next generation display products. As flat panel display resolution and size increase, new challenges emerge that must be addressed to ensure a corresponding improvement in video quality. For example, the challenge of judder becomes more of an issue with larger screens. Judder occurs when content recorded at one rate of frames per second for film content must be converted to faster video rates, and as a result there is a jerkiness, or judder in the resulting video performance. This problem is intensified in larger displays and can be a problem regardless of the panel technology being used.

In addition to judder, LCD panels also suffer from blur in motion images as a result of the way the human brain processes the longer frame durations produced by an LCD panel. In the past, LCD panel manufacturers have tried to reduce blur by increasing the refresh rate of the panel from 50/60Hz to 100/120Hz and higher rates and inserting an extra black frame to reduce frame duration. But the black frame insertion method has had drawbacks one of which was to make LCD screen seem less bright. Newer motion estimation/motion compensation ( MEMC ) technology uses the insertion of interpolated frames based on complex mathematical algorithms to shorten the duration of the video frame and create a clearer, crisper picture. MEMC also provides de-judder processing that smoothes out the jerkiness often apparent with large screen displays.

Reducing judder and blur and addressing other performance issues is critical to delivering high quality video, particularly at the high end of the market where more expensive, larger panels exacerbate the problem. To differentiate their products, advanced flat panel manufacturers must implement technology that addresses these video performance problems as rapidly, as fully and as cost effectively as possible.

Looking forward, the convergence of video and the Internet will present new challenges to video processing, as low quality Internet video content increasingly will be required to be displayed at higher resolutions. Additional limitations in bandwidth, latency, noise and content resolution create significant challenges for displaying Internet video on full HD flat panel displays. Video processors must be able to scale poorer quality video, reduce signal noise inherent to networks and enhance image quality in order to ensure optimal video performance.

***Digital Projection Market***

Increasingly affordable price points are driving continued adoption of digital projectors in business and education, as well as among consumers. Technology improvements are helping reduce the size and weight of projection devices and increasing their performance. Projector models range from larger units designed to be permanently installed in a conference hall or other venue, to ultra portable devices weighing less than two pounds for maximum portability.

Currently, the largest segment of the installed front projector market consists of business users who employ multimedia projectors to display both still and video presentation materials from PCs or other sources. Requirements for the business market include portability, compatibility with multiple software and hardware applications and

features that ensure simple operation. Growth in overall projector sales is expected to come both from the business sector and the education market. In educational environments from elementary schools to university campuses, projectors help teachers integrate media-rich instruction into classrooms. Among consumers, multimedia projectors provide a cinematic experience in a home theater environment; however, growth in the consumer sector is unlikely to resume until the global economic environment improves.

Table of Contents

Worldwide, the emerging economies of Brazil, Russia, India and China, commonly referred to collectively as BRIC, are expected to be a leading driver of demand for information technology of all kinds, including projectors for business, education and the consumer sectors.

Consistent with the trends of other consumer products, digital projectors are increasingly incorporating networking capabilities that enable the sharing of video and other content among multiple devices.

***Additional Markets***

In addition to the advanced flat panel and digital projection markets, other sectors are also taking advantage of the trend towards higher performance and connectivity in digital video technology. Some of the applications expected to grow as a result of enhanced video quality include digital signage, video conferencing and video surveillance. Large format flat panel displays for digital signage applications, such as in restaurants and mass transit, are forecast to grow at a compound annual growth rate of 32% over the next five years, according to DisplaySearch.

**Our Technologies and Products**

Our technology enables electronics manufacturers to deliver products with high-quality video performance. We have a portfolio of advanced video algorithms and intellectual property that addresses a broad range of challenges in digital video.

Our product development strategy is to leverage our expertise in video processing to address the evolving needs of the advanced flat panel display, digital projection and other markets that require superior image quality. We plan to continue to focus our development resources to maintain our market lead in the digital projection market and to enhance our video processing solutions for advanced flat panel displays and other markets. Additionally, we look for ways to leverage our research and development investment into products that address high-value markets where our innovative proprietary technology provides differentiation for us and our customers. We deliver our technology in a variety of offerings, which take the form of single-purpose chips, highly integrated SoCs that incorporate specialized software, and full solutions incorporating software and other tools.

During 2008, we introduced three new products that we consider both innovative and important for the markets they address.

We introduced both first and second generations of our PW9800 DNX® MotionEngine™, which leverages MEMC technology to significantly improve the performance and viewing experience of large advanced LCD panels by significantly reducing motion blur and judder. It also improves video performance in multimedia projectors and a range of consumer products requiring 120Hz support.

Our PW610 digital projection post processor, based on Pixelworks proprietary ARK™ Engine technology, provides enhanced keystone and image correction performance for digital projection systems.

Our PWC950 networked display processor enables the same video stream to be networked across multiple displays, for applications such as connected video projection and digital signage.

***Our Products***

Our primary product categories include the following:

***ImageProcessor ICs.*** Our ImageProcessor ICs include embedded microprocessors, digital signal processing technology and software that control the operations and signal processing within high-end display systems such as projectors and high-resolution flat panels. Products in this category include technology for advanced image scaling, aspect ratio conversion, color compensation, customizable on-screen display and automatic image optimization. Our ImageProcessor ICs can also include the following additional functions: advanced de-interlacing circuitry; digital keystone

correction; an analog-to-digital controller; a Digital Visual Interface, or DVI[tm]; and a High-Definition Multimedia Interface, or HDMI[tm].

ImageProcessor ICs were our first product offerings and continue to comprise the majority of our business. We have continued to refine the architectures for optimal performance, manufacturing our products on process technologies that align with our customers requirements. Additionally, we provide a software development environment and operating system that enables our customers to more quickly develop and customize the look and feel of their products.

***Video Co-Processor ICs.*** Products in this category post-process video signals in conjunction with an image processor to enhance the performance or feature set of the overall video solution (for example, by significantly reducing judder and motion blur). Our video co-processor ICs can be used with our ImageProcessor ICs or with image processing solutions from other manufacturers, and in most cases can be incorporated by a display manufacturer without assistance from the supplier of the base image processor. This flexibility enables manufacturers to augment their existing or new designs to enhance their video display products. By offering these co-processor ICs, we can target specific needs in our markets and implement technologies optimally without making compromises to accommodate the demands of integration.

***Networked Display ICs.*** Our Networked Display ICs allow the same video stream to be networked across multiple displays, for example to connect projectors in different classrooms or to network video in digital signage applications. Our Networked Display IC combines video sharing capabilities with video image processing, wireless connectivity and Internet connection to ensure high quality, multi-source video output and enhanced value to our projection display customers.

***Broadband Signal Processor ICs.*** Our Broadband Signal Processor ICs are programmable SoC ICs for video conferencing, video surveillance and other industrial video applications using multiple industry-standard compression decoding schemes. Broadband Signal Processor ICs provide flexible solutions for a variety of image processing tasks, such as video compression.

**Our Core Technologies**

We have developed a portfolio of advanced video algorithms and intellectual property to address a broad range of challenges in digital video. In order to address our customers needs, our products are designed with a flexible architecture that allows us to combine algorithms and functional blocks of digital and mixed signal circuitry. Accordingly, our technologies can be implemented across multiple products. The majority of our products include one or more of the following technologies to provide high-quality video solutions to our customers. The following is a description of our core technologies:

***Adaptive Image Optimization.*** Our products must translate a broad range of signals in standard and non-standard formats. We use a proprietary image processing technique to identify the characteristics of an incoming signal and configure the system to produce the best possible image.

***Advanced Image Scaling and Shaping.*** We have developed innovative, industry-leading image scaling technologies that intelligently enlarge or compress images for display in different resolutions or aspect ratios, which is the ratio of width to height of display screens.

***Chroma Key Window.*** Chroma Key Window technology enables improved video performance on hybrid PC-TV systems. The Chroma Key Window creates a flexible, resizable picture-in-picture window that displays an alternative video source such as a set-top box or DVD player. The advantage is better image quality, since the content is

displayed using hardware to perform the video processing rather than relying on the PC to handle it, which burdens the microprocessor and uses software video processing, generally resulting in lower image quality.

***Color Compensation Technology.*** Our sophisticated custom color compensation technology makes it possible to display consistent color images from video and computer graphics, which use very different color palettes, on different display devices. Our color processing technology

compensates for variations in the color performance of a display. Using our approach, any color can be addressed independently and adjusted without impacting other colors.

***Digital Keystone Correction.*** We pioneered digital keystone correction technology, which is now established as a key feature in multimedia projectors. When projecting an image, if the digital projector is not perpendicular to the surface on which it is projecting the image, the image will be distorted. Our digital keystone correction modifies the geometry of the image in our ImageProcessor IC so that it will appear that the image is squared up. Our latest digital keystone correction technology, ARK Engine*,* offers a unique approach to keystone correction for full HD resolution systems.

***DNX MotionEngine.*** DNX MotionEngine utilizes MEMC technology to significantly reduce motion artifacts, often referred to as judder and blur. Our DNX MotionEngine uses proprietary algorithms to dramatically improve motion performance in large, flat panel, high-resolution TVs.

***Dynamic Deblocking.*** This technology smoothes blocking artifacts that are common in moving picture experts group ( MPEG ) encoded content. MPEG digital compression techniques can introduce visual artifacts that appear as visible blocks in the video image. Our dynamic deblocking technology is able to detect these artifacts and implements proprietary algorithms to eliminate the edges of the blocks and improve image quality.

***Fully Customizable On-Screen Display.*** Our technology couples an integrated on-screen display controller with our industry-first development application. These technologies allow customers who are designing ImageProcessor semiconductors into their display products to quickly develop and implement their own unique user interfaces with up to 256 colors that can incorporate graphics and colorful icons in start-up displays and menus.

***Motion-Adaptive De-Interlacing.*** We have developed a proprietary video processing technology to convert interlaced content into progressive content that minimizes image artifacts such as stair-stepping, often referred to as jaggies, that can occur with less sophisticated techniques. Our motion-adaptive de-interlacing is able to analyze the content and apply the most appropriate methods for both standard television formats and also high definition television ( HDTV ) formats. In addition, motion-adaptive de-interlacing automatically recognizes when incoming signals were originally captured on film so that special methods are employed to display the content.

***Noise Reduction.*** Digital displays often appear to create movement where none exists because pixels flicker in areas where there is no motion, creating a distracting shimmering effect. This is referred to as noise. We have developed proprietary technology that minimizes noise for a stable, accurate video image.

***PixelAmp™ Color Processing.*** PixelAmp color processing is a proprietary video processing technique that increases color performance and enhances edges for more brilliant, crisper images. For lower resolution content, PixelAmp technology recovers clarity, which improves the consumer viewing experience especially in high-end television systems. The PixelAmp technology also includes a demonstration mode that can display an image showing side-by-side screens of content with and without the edge and color enhancements, which is useful for differentiating products in retail environments.

**Customers, Sales and Marketing**

The key focus of our sales and marketing strategy is to achieve design wins with industry leading branded manufacturers in targeted markets and to continue building strong customer relationships. Once a design win has been achieved, sales and marketing efforts are focused on building long-term mutually beneficial business relationships with our customers by providing superior technology and reducing their costs, which complements our customers product development objectives and meets their expectations for price-performance and time to market. Marketing

efforts are focused on building market-leading brand awareness and preference for our solutions.

Table of Contents

Our sales and marketing team had 48 employees as of December 31, 2008, including 18 field application engineers who provide technical expertise and assistance to manufacturing customers on final product development. We have sales, marketing and support personnel in the U.S., China, Taiwan, Japan and Korea.

Our global distribution channel is multi-tiered and involves:

***Distributors.*** Distributors are resellers in local markets who provide engineering support and stock our semiconductors in direct relation to specific manufacturing customer orders. Our distributors often have valuable and established relationships with our end customers, and in certain countries it is customary to sell to distributors. While distributor payment to us is not dependent upon the distributor s ability to resell the product or to collect from the end customer, our distributors may provide longer payment terms to end customers than those we would offer. Sales to distributors accounted for 53%, 57% and 52% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively.

Our largest distributor, Tokyo Electron Device Ltd. ( TED ), is located in Japan. TED represented 32%, 33% and 26% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively, and accounted for 32% and 27% of accounts receivable at December 31, 2008 and 2007, respectively. No other distributor accounted for more than 10% of revenue during the years ended December 31, 2008, 2007 and 2006.

We also have distributor relationships in China, Europe and the U.S.

***Direct Relationships.*** We have established direct relationships with companies that manufacture high-end display systems. Some of our direct relationships are supported by manufacturers representatives, who are independent sales agents that represent us in local markets and provide engineering support but do not carry inventory. Revenue through direct relationships accounted for 47%, 43% and 48% of total revenue for the years ended December 31, 2008, 2007 and 2006, respectively.

We have direct relationships with companies falling into the following three classifications:

*Integrators.* Integrators are original equipment manufacturers ( OEMs ) who build display devices based on specifications provided by branded suppliers.

*Branded Manufacturers.* Branded manufacturers are globally recognized manufacturers who develop display device specifications, and manufacture, market and distribute display devices either directly or through resellers to end-users.

*Branded Suppliers.* Branded suppliers are globally recognized suppliers who develop display device specifications and then source them from integrators, typically in Asia, and distribute them either directly or through resellers to end-users.

Revenue attributable to our top five end customers represented 55%, 47% and 39% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. End customers include customers who purchase directly from us as well as customers who purchase products indirectly through distributors and manufacturers representatives. During 2008, we sold product directly to Seiko Epson Corporation who represented 24% of revenue for the year ended December 31, 2008 and accounted for 20% of accounts receivable at December 31, 2008. Revenue attributable to Seiko Epson Corporation was 21% and 15% of revenue for the years ended December 31, 2007 and 2006, respectively. No other end customer accounted for more than 10% of revenue during the years ended December 31, 2008, 2007 and 2006.

**Seasonality**

Our business is subject to seasonality related to the markets we serve and the location of our customers. We have historically experienced higher revenue from the multimedia projector market in the third quarter of the year, and lower revenue in the first quarter of the year as our Japanese customers reduce inventories in anticipation of their March 31 fiscal year ends. Additionally, holiday demand for consumer electronics,

including high-end televisions, has contributed to increased revenue in the second half of certain years. Our sales in 2008 did not follow our historical trends due to the global crisis in the credit and financial markets and significant reductions in consumer spending during the second half of 2008. As a result of the worldwide economic slowdown, it is extremely difficult for us to determine when or if historical trends are likely to resume.

**Geographic Distribution of Sales**

Sales outside the U.S. accounted for approximately 95% of our revenue in 2008 and 96% of our revenue in 2007 and 2006.

Our global operations subject us to risks and difficulties associated with doing business outside the U.S. These risks include foreign currency exchange rate fluctuations, political and economic instability, reduced or limited protection of our intellectual property and increased transaction costs. Our global operations also increase the complexity of our relationships with our distributors and manufacturers due to varying time zones, languages and business customs.

Financial information regarding our domestic and foreign operations is presented in Note 11 of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements and Supplementary Data.

**Backlog**

Our sales are made pursuant to customer purchase orders for delivery of standard products. The volume of product actually purchased by our customers, as well as shipment schedules, are subject to frequent revisions that reflect changes in both the customers needs and product availability. Our entire order backlog is cancelable, with a portion subject to cancellation fees. In light of industry practice and our own experience, we do not believe that backlog as of any particular date is indicative of future results.

**Competition**

In general, the semiconductor industry is intensely competitive. The markets for higher performance display and projection devices, including the markets for advanced flat panel display televisions, multimedia projectors and other applications demanding high quality video, are characterized by rapid technological change, evolving industry standards, compressed product life cycles and declining average selling prices. We believe the principal competitive factors in our markets are levels of product integration, compliance with industry standards, time to market, cost, product performance, system design costs, intellectual property ( IP ), functional versatility provided by software and customer relationships and reputation.

Our current products face competition from specialized display controller developers and in-house display controller ICs designed by our customers and potential customers. Additionally, new alternative display processing technologies and industry standards may emerge that directly compete with technologies that we offer.

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

Corporation, NXP Semiconductors, Samsung Electronics Co., Ltd., SANYO Electric Co., Ltd., Seiko Epson Corporation, Sharp Electronics Corporation, Sony Corporation, Texas Instruments Incorporated and Toshiba America, Inc. In addition, start-up companies may seek to compete in our markets.

### Research and Development

Our internal research and development efforts are focused on the development of our solutions for the multimedia projector and high-end television markets. Our development efforts are focused on pursuing higher levels of video performance, integration and new features in order to provide our customers with solutions that enable them to introduce market leading products and help lower final systems costs for our customers.

On December 31, 2008, we had 130 engineers, technologists and scientists. We have invested, and expect to continue to invest, significant resources in research and development activities. Our research and development expense was $26.5 million, $38.8 million and $57.0 million in 2008, 2007 and 2006, respectively.

### Manufacturing

Our products require advanced semiconductor processing and packaging technologies. Within the semiconductor industry we are known as a fabless company, meaning that we do not manufacture the semiconductors that we design and develop but instead rely on third parties to manufacture our products. We contract with third-party foundries for wafer fabrication and other manufacturers for packaging, assembly and testing of our products. The fabless approach allows us to concentrate our resources on product design and development where we believe we have greater competitive advantages.

Our wafers are fabricated by Semiconductor Manufacturing International Corporation ( SMIC ), Taiwan Semiconductor Manufacturing Corporation and Toshiba Corporation. Although we have well established relationships with each of these suppliers, including an equity investment in SMIC, the wafers used in each of our products are fabricated by only one of these manufacturers. Since we sole source each of our products and the lead-time needed to establish a relationship with a new contract manufacturer is at least nine months, and the estimated time for us to adapt a product s design to a particular contract manufacturer s process is at least four months, there is no readily available alternate supply for any specific product. In addition, 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. From time to time, our contract manufacturers increase prices charged to produce our products with little notice.

### Intellectual Property

We rely on a combination of nondisclosure agreements and copyright, trademark and trade secret laws to protect the algorithms, design and architecture of our technology. Currently, we hold 90 patents and have 64 patent applications pending, which relate generally to improvements in the visual display of digital image data including, but not limited to, improvements in image scaling, image correction, automatic image optimization and video signal processing for digital displays. Our U.S. and foreign patents are generally enforceable for 20 years from the date they were filed. Accordingly, our issued patents have from approximately 2 to 17 years remaining in their respective term, depending on their filing date.

We intend to seek patent protection for other significant technologies that we have already developed and expect to seek patent protection for future products and technologies as necessary. Patents may not be issued as a result of any pending applications and any claims allowed under issued patents may be insufficiently broad to protect our technology. Existing or future patents may be invalidated, circumvented, challenged or licensed to others.

To supplement the technologies we develop internally, we have licensed rights to use IP held by third parties, and we may license additional technology rights in the future. We typically license technology from third parties and have

agreed to pay certain suppliers a royalty based on the number of chips sold or manufactured, the net sales price of the chips containing the licensed technology or a fixed non-cancelable fee. If any of these agreements terminate, we would be required to exclude the licensed technology from our existing and future product lines.

The semiconductor industry is characterized by frequent litigation regarding patent and other IP rights. We have indemnification obligations with respect to the infringement of third party IP rights. There is no IP litigation currently pending against us. However, we may, from time to time, receive notification of claims that we may be infringing patents or other IP rights owned by third parties. If it is necessary or desirable, we may seek licenses under those patents or IP rights. However, we cannot be sure that licenses will be offered or that the terms of any offered licenses would be acceptable to us.

**Environmental Matters**

We are subject to numerous environmental laws and regulations. In recent years, various federal, state and international governments have enacted laws and regulations governing the collection, treatment, recycling and disposal of certain materials used in the manufacturing of electrical and electronic components. For example, the European Parliament finalized the Restriction of Hazardous Substances Directive, or RoHS, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead. The European Parliament also finalized the Waste Electrical and Electronic Equipment Directive, or WEEE Directive, which makes producers of electrical and electronic equipment financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Additionally, some jurisdictions have begun to require various levels of Electronic Product Environmental Assessment Tool ( EPEAT ) certification, which are based on the Institute of Electrical and Electronics Engineers 1680 standard. The highest levels of EPEAT certification restrict the usage of halogen. Although our older generation products, many of which are still shipping to customers, do contain halogen, our next generation designs do not. We have worked, and continue to work internally, with our suppliers and with our customers to ensure that products we put on the market are compliant with enacted laws and regulations. Failure to comply with such legislation could result in our customers refusing to purchase our products and subject us to significant monetary penalties in connection with a violation.

Environmental laws and regulations are complex, change frequently and have tended to become more stringent over time. We have incurred, and may continue to incur, significant expenditures to comply with these laws and regulations and we may incur additional capital expenditures and asset impairments to ensure that our products and our vendors products are in compliance with these regulations. We would be subject to significant penalties for failure to comply with these laws and regulations.

**Employees**

As of December 31, 2008, we had a total of 229 employees comprised of 130 in engineering; 48 in sales and marketing, of which 18 are field application engineers and 30 are sales and marketing staff; 18 in operations; and 33 in administration, including finance, information technology, human resources and general administration. Of the 229 employees, 50 were located in the United States as of December 31, 2008. None of our employees are represented by a collective bargaining agreement, nor have we experienced any work stoppage. We consider our relationship with our employees to be good. Our future success will depend in large part on our ability to continue to attract, retain and motivate highly skilled and qualified personnel.

**Availability of Securities and Exchange Commission Filings**

We make available through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports free of charge as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission. Our Internet address is *www.pixelworks.com*. The content on, or that can be accessed through, our website is not incorporated by reference into this filing. Documents filed by us with the Securities and Exchange Commission may be read and copied at the Public Reference Section of the SEC, 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation

of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. Our filings with the SEC are also available to the public through the SEC s website at *www.sec.gov*.

Table of Contents

## 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 Annual Report on Form 10-K for the year ended December 31, 2008, including our consolidated financial statements and related notes, and our other filings made from time to time with the Securities and Exchange Commission.*

***The current crisis in global credit and financial markets could materially and adversely affect our business and results of operations.***

Financial markets have experienced extreme disruption in recent months, including, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades of certain investments and declining valuations of others. There can be no assurance that there will not be further deterioration in credit and financial markets and confidence in economic conditions. While we do not currently require access to credit markets to finance our operations, these economic developments have affected, and are likely to continue to affect, our business in a number of ways. For instance, the economic crisis may decrease market acceptance of our products and reduce the demand for our products and the success of our product strategy. We face an increased risk that our customers will be unable to continue their operations and it may become more difficult to collect payments from our customers on a timely basis, or at all. In addition, the current tightening of credit in financial markets may also adversely affect the ability of our end customers and suppliers to obtain financing for significant purchases and operations and has resulted, and is likely to continue to result, in a decrease in, or cancellation of, orders for our products or reduced ability to finance operations to supply products to us. As a result of the worldwide economic slowdown, it is extremely difficult for us and our customers to forecast future sales levels based on historical information and trends. Portions of our expenses are fixed and other expenses are tied to expected levels of sales activities. To the extent that we do not achieve our anticipated level of sales, our gross profit and net income could be adversely affected until such expenses are reduced to an appropriate level. Additionally, if we are unable to reduce our costs to respond to future decreases in revenue, we may utilize more of our cash resources than we planned. Any future actions that we take to limit our usage of cash may also reduce our ability to execute on our plans and strategies. We are unable to predict the likely duration and severity of the current disruption in financial markets and adverse economic conditions in the U.S. and other countries.

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

We have adopted a product strategy that focuses on our core competencies in pixel processing and delivering high levels of video and image quality. With this strategy, we continue to make further investments in development of our ImageProcessor architecture for the digital projector market, with particular focus on adding increased performance and functionality. For the advanced television market, we are shifting away from our previous approach of implementing our intellectual property ( IP ) exclusively in system-on-chip integrated circuits ( ICs ), to an approach designed to improve video performance of our customers image processors through the use of a co-processor IC. This strategy is designed to address the needs of the large-screen, high-resolution, high-quality segment of the advanced television market. Additionally, we are focusing certain of our research and development efforts on new areas beyond our traditional applications, which may not result in increased revenue or gross profit.

We have designed our new strategy to help us take advantage of expected market trends. While we have secured design wins with our new products, our expectations may not be accurate and these markets may not develop or they may take longer to develop than we expect. We cannot assure you that the products we are developing to address our new strategy will adequately address the needs of our target customers, that we will

be able to produce our new products at costs that enable us to price these products competitively or that our customers or potential customers will accept our products quickly enough or in sufficient volume to grow revenue and gross profit. Additionally, the current economic crisis may alter current market trends and reduce the demand for our products and the success of our product strategy. A lack of market acceptance or insufficient market acceptance would materially and adversely affect our results of operations.

***We have incurred substantial indebtedness as a result of the sale of convertible debentures and may be unable to meet our future capital requirements.***

As of December 31, 2008, $60.6 million of our 1.75% convertible subordinated debentures due 2024 were outstanding. In February 2009, we repurchased and retired $27.1 million of the debentures for $17.8 million in cash, reducing the balance of our outstanding debentures to $33.5 million. Although the remaining debt obligations are due in 2024, the holders of debentures have the right to require us to purchase all or a portion of the outstanding debentures at each of the following dates: May 15, 2011, May 15, 2014 and May 15, 2019. Since the market price of our common stock is significantly below the conversion price of the debentures, the holders of our outstanding debentures are unlikely to convert the debentures into common stock in accordance with the existing terms of the debentures. Accordingly, we expect holders of the debentures to exercise a put option, requiring us to purchase all of the outstanding debentures on May 15, 2011, the earliest date allowed. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, some of which are beyond our control. Additionally, due to recent turmoil in the credit markets and the continued decline in the economy, we may not be able to refinance the debentures at terms that are as favorable as those currently contained in the debentures, or at terms that are acceptable to us at all. These debentures could materially and adversely affect our ability to obtain additional debt or equity financing for working capital, acquisitions or other purposes, limit our flexibility in planning for or reacting to changes in our business, reduce funds available for use in our operations and make us more vulnerable to industry downturns and competitive pressures.

While we believe that our current cash and marketable securities balances will be sufficient to meet our capital requirements for the next twelve months, we cannot assure you that we will be able to maintain sufficient cash and marketable security balances to refinance or pay off the convertible debentures when and if the put option is exercised. We may need, or could elect to seek, additional funding through public or private equity or debt financing, which we may not be able to obtain. If we issue equity securities, our shareholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of our common stock.

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

***The June 4, 2008 one-for-three reverse split of outstanding shares of our common stock has not resulted in a material increase in the bid price of our common stock and we may be unable to maintain compliance with NASDAQ Marketplace Rules without taking additional action, which could include effecting an additional reverse stock split. If we are delisted from the NASDAQ Global Market, there may not be a market for our common stock, which could cause a decrease in the value of an investment in us and adversely affect our business, financial condition and results of operations.***

On June 4, 2008, we effected a one-for-three reverse split of our common stock. We effected the reverse split to attempt to regain compliance with NASDAQ Marketplace Rules, particularly the minimum $1.00 per share requirement for continued inclusion on the NASDAQ Global Market. Though the per share price of our

common stock increased to over $2.00 per share immediately following the reverse split, the price has since closed below $1.00 per share and we cannot guarantee that it will recover to $1.00 per share. If the price does not recover to $1.00 per share, the stock could become subject to delisting again, and we may seek shareholder approval for an additional reverse split. Although NASDAQ has implemented a temporary suspension of the $1.00 minimum bid price requirement, this requirement is scheduled for reinstatement on April 20, 2009.

A second reverse split could produce negative effects. We could not guarantee that an additional reverse split would result in a long-term or permanent increase in the price of our common stock. The market might perceive a decision to effect an additional reverse split as a negative indicator of our future prospects, and as a result, the price of our common stock might decline after such a reverse split (perhaps by an even greater percentage than would have occurred in the absence of such a reverse split). An additional reverse split could also make it more difficult for us to meet certain other requirements for continued listing on the NASDAQ Global Market, including rules related to the minimum number of shares that must be in the public float, the minimum market value of the public float and the minimum number of round lot holders. Investors might consider the increased proportion of unissued authorized shares to issued shares to have an anti-takeover effect under certain circumstances by allowing for dilutive issuances which could prevent certain shareholders from changing the composition of the board, or could render tender offers for a combination with another entity more difficult to complete successfully. Additionally, customers, suppliers or employees might consider a company with low trading volume risky and might be less likely to transact business with us.

If our common stock is delisted, trading of the stock will most likely take place on an over-the-counter market established for unlisted securities, such as the Pink Sheets or the OTC Bulletin Board. An investor is likely to find it less convenient to sell, or to obtain accurate quotations in seeking to buy, our common stock on an over-the-counter market, and many investors may not buy or sell our common stock due to difficulty in accessing over-the-counter markets, or due to policies preventing them from trading in securities not listed on a national exchange or other reasons. In addition, as a delisted security, our common stock would be subject to SEC rules regarding penny stock, which impose additional disclosure requirements on broker-dealers. The regulations relating to penny stocks, coupled with the typically higher cost per trade to investors in penny stocks due to factors such as broker commissions generally representing a higher percentage of the price of a penny stock than of a higher priced stock, would further limit the ability and willingness of investors to trade in our common stock. For these reasons and others, delisting would adversely affect the liquidity, trading volume and price of our common stock, causing the value of an investment in us to decrease and having an adverse effect on our business, financial condition and results of operations, including our ability to attract and retain qualified executives and employees and to raise capital.

***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. Market fluctuations, particularly over the past several months, as well as general economic and political conditions, including recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our common stock. Therefore, the price of our common stock may decline, and the value of your investment may be reduced regardless of our performance. Any 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. Additional factors that could negatively impact our stock price include:

- actual or anticipated fluctuations in our operating results;
- changes in expectations as to our future financial performance;

changes in financial estimates of securities analysts;

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

the operating and stock price performance of other comparable companies;

announcements of future expectations by our customers;

changes in market valuations of other technology companies; and

inconsistent trading volume levels of our common stock.

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

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

We compete with specialized and diversified electronics and semiconductor companies that offer display processors or scaling components. Some of these include Broadcom Corporation, i-Chips Technologies Inc., Integrated Device Technology, Inc., Jepico Corp., MediaTek Inc., Micronas Semiconductor Holding AG, MStar Semiconductor, Inc., Realtek Semiconductor Corp., Renesas Technology Corp., Sigma Designs, Inc., Silicon Image, Inc., STMicroelectronics N.V., Sunplus Technology Co., Ltd., Techwell, Inc., Topro Technology Inc., Trident Microsystems, Inc., Weltrend Semiconductor, Inc., Zoran Corporation and other companies. Potential and current competitors may include diversified semiconductor manufacturers and the semiconductor divisions or affiliates of some of our customers, including Intel Corporation, LG Electronics, Inc., Matsushita Electric Industrial Co., Ltd., Mitsubishi Digital Electronics America, Inc., National Semiconductor Corporation, NEC Corporation, NVIDIA Corporation, NXP Semiconductors, Samsung Electronics Co., Ltd., SANYO Electric Co., Ltd., Seiko Epson Corporation, Sharp Electronics Corporation, Sony Corporation, Texas Instruments Incorporated and Toshiba America, Inc. In addition, start-up companies may seek to compete in our markets.

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

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

Our future success depends on developers of advanced display products designing our products into their systems. To achieve design wins, we must define and deliver cost-effective, innovative and integrated semiconductors. Once a supplier s products have been designed into a system, the developer may be reluctant to change its source of components due to the significant costs associated with qualifying a new supplier. Accordingly, it may be difficult for

us to achieve additional design wins. The failure on our part to obtain additional design wins with leading branded manufacturers or integrators, and to successfully design, develop and introduce new products and product enhancements could seriously limit our ability to grow.

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

***Despite our restructuring efforts, we may not achieve profitability in the future and, if we do, we may not be able to sustain or increase profitability on a quarterly or annual basis. If we are not profitable in the future, we may be unable to continue our operations.***

In 2006, we initiated restructuring plans, which we implemented throughout 2007 and 2008, aimed at returning the Company to profitability. In December 2008, we initiated a restructuring plan to reduce our operating expenses due to decreases in current and forecasted revenue. The plan reduces operations, research and development and administrative headcount in our San Jose, Taiwan and China offices, and we expect the plan to be substantially complete in the first quarter of 2009. We cannot be certain that these plans will be successful or that future restructuring efforts will not be necessary. We will continue to monitor and evaluate the need for additional restructuring actions in light of global economic uncertainty and its potential impact on our continuing business, however uncertainty regarding the outlook for 2009 and beyond impedes our ability to forecast the scope and impact of these actions.

Despite our restructuring efforts, we may not achieve profitability in the future and, if we do, we may not be able to sustain or increase profitability on a quarterly or annual basis. The years ended December 31, 2004 and December 31, 2008 are our only years of profitability since inception and we may be unable to achieve profitability in future periods. Additionally, our profitability in 2008 was primarily the result of gains we recognized on the repurchase of a portion of our convertible subordinated debentures. We did not achieve operating profits in 2008. If we are not profitable in the future, we may be unable to continue our operations.

***If we engage in further restructuring efforts, we may be unable to successfully implement new products or enhancements to our current products, which will adversely affect our future sales and financial condition.***

We expect to continue to introduce new and enhanced products, and our future sales will depend on customer acceptance of our new products and the enhancements that we may make to our current products. However, if our recent restructuring efforts are insufficient to reduce our cost structure to a level that is commensurate with our revenue, we may be forced to make additional headcount reductions or implement additional cost saving initiatives. These actions could impact our research and development and engineering activities, which may slow our development of new or enhanced products. If we are unable to successfully introduce new or enhanced products, our sales and financial condition will be adversely affected.

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

The markets in which we compete or seek to compete are subject to rapid technological change, frequent new product introductions, changing customer requirements for new products and features and evolving industry standards. The introduction of new technologies and emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Examples of changing industry standards include the growing use of broadband to deliver video content, the transition from 720 High Definition to 1080p Full High Definition resolution

video, faster screen refresh rates, the proliferation of new display devices and the drive to network display devices together. Our failure to adequately respond to such technological changes could render our products obsolete or significantly decrease our revenue.

Table of Contents

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

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

- accurate prediction of customer requirements and evolving industry standards;
- development of advanced display technologies and capabilities;
- use of advanced foundry processes and achievement of high manufacturing yields; and
- market acceptance of new products.

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

***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 and North America. For example, the current global economic crisis has caused a slowdown in the demand for our products and other semiconductor products in general, and such slowdown may continue for an extended period of time. The cyclical nature of the semiconductor industry has led to significant variances in product demand and production capacity. We have experienced, and may continue to experience, periodic fluctuations in our future financial results because of changes in industry-wide conditions.

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

We develop products based on anticipated market and customer requirements and incur substantial product development expenditures, which can include the payment of large up-front, third-party license fees and royalties, prior to generating associated revenue. Our work under these projects is technically challenging and places considerable demands on our limited resources, particularly on our most senior engineering talent.

Because the development of our products incorporates not only our complex and evolving technology but also our customers specific requirements, a lengthy sales process is often required before potential customers begin the

technical evaluation of our products. Our customers typically perform numerous tests and extensively evaluate our products before incorporating them into their systems. The time required for testing, evaluation and design of our products into a customer s system can take up to nine months or more. It can take an additional nine months or longer before a customer commences volume shipments of systems that incorporate our products. We cannot assure you that the time required for the testing, evaluation and design of our products by our customers would not be significantly longer than nine months.

Table of Contents

Because of the lengthy development and sales cycles, we will experience delays between the time we incur expenditures for research and development, sales and marketing and inventory and the time we generate revenue, if any, from these expenditures. Additionally, if actual sales volumes for a particular product are substantially less than originally anticipated, we may experience large write-offs of capitalized license fees, software development tools, product masks, inventories or other capitalized or deferred product-related costs, or increased amortization of non-cancelable prepaid royalties, any of which would negatively affect our operating results. For example, our provisions for obsolete inventory were $1.5 million, $4.4 million and $6.2 million for the years ended December 31, 2008, 2007 and 2006, respectively. Additionally, in 2007, we wrote-off assets with a net book value of $6.9 million due to reductions in research and development personnel and changes in product development strategy.

***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. Our operating results are negatively affected when revenue or gross profit declines. We have experienced declines in our average selling prices and expect that we will continue to experience them in the future, although we cannot predict when they may occur or how severe they will be. The current crisis in global credit and financial markets may result in more rapid declines in average selling prices, as potential customers have less cash available for purchases and operations and, in some instances, exit the market. Our financial results will suffer if we are unable to offset any reductions in our average selling prices by increasing our sales volumes, reducing our costs, adding new features to our existing products or developing new or enhanced products in a timely basis with higher selling prices or gross profits.

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

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

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

The display manufacturing market is highly concentrated and we are, and will continue to be, dependent on a limited number of customers and distributors for a substantial portion of our revenue. Sales to distributors represented 53%, 57% and 52% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Sales to Tokyo Electron Device, or TED, our Japanese distributor, represented 32%, 33% and 26% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Revenue attributable to our top five end customers represented

55%, 47% and 39% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Sales to Seiko Epson Corporation, our top end customer, represented 24%,



---

Table of Contents

21% and 15% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. A reduction, delay or cancellation of orders from one or more of our significant customers, or a decision by one or more of our significant customers to select products manufactured by a competitor or to use its own internally-developed semiconductors, would significantly impact our revenue. For example, our loss of a key OEM customer in Europe contributed to a $45.5 million, or 51%, decrease in advanced television revenue from 2005 to 2006.

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

As of December 31, 2008 and 2007 we had three and two customers, respectively, that each represented 10% or more of accounts receivable. The concentration of our accounts receivable with a limited number of customers increases our credit risk. The failure of these customers to pay their balances, or any other customer to pay future outstanding balances, would result in an operating expense and reduce our cash flows.

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

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

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

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

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

- the board of directors may alter our bylaws without obtaining shareholder approval; and

- shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting.

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

Selling to distributors and integrators reduces our ability to forecast sales accurately and increases the complexity of our business. Since our distributors act as intermediaries between us and the companies using our products, we must rely on our distributors to accurately report inventory levels and production forecasts. We must similarly rely on our

integrators. Our integrators are original equipment manufacturers ( OEMs ) that build display devices based on specifications provided by branded suppliers. Selling to distributors and OEMs adds another layer between us and the ultimate source of demand for our products, the consumer. These arrangements require us to manage a complex supply chain and to monitor the financial condition and creditworthiness of our distributors, integrators and customers. They also make it more difficult for us to predict demand for our products. Our failure to manage one or more of these challenges could result in excess

inventory or inventory shortages that could materially impact our operating results or limit the ability of companies using our semiconductors to deliver their products.

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

We license technology from independent third parties that is incorporated into our products or product enhancements. Future products or product enhancements may require additional third-party licenses that may not be available to us or may not be available on terms that are commercially reasonable. In addition, in the event of a change in control of one of our licensors, it may become difficult to maintain access to its licensed technology. If we are unable to obtain or maintain any third-party license required to develop new products and product enhancements, we may have to obtain substitute technology with lower quality or performance standards, or at greater cost, either of which could seriously harm the competitiveness of our products.

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

Our ability to compete effectively with other companies will depend, in part, on our ability to maintain the proprietary nature of our technology, including our semiconductor designs and software. We provide the computer programming code for our software to customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to help protect our proprietary technologies. As of December 31, 2008 we held 90 patents and had 64 patent applications pending for protection of our significant technologies. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources than we do, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or they may develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries.

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

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

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

- stop selling products using technology that contains the allegedly infringing IP;
- attempt to obtain a license to the relevant IP, which may not be available on reasonable terms or at all;
- attempt to redesign those products that contain the allegedly infringing IP; or

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

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

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

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

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

Sales outside the U.S. accounted for approximately 95% of revenue for the year ended December 31, 2008 and 96% of revenue for the years ended December 31, 2007 and 2006. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenue in future periods. In addition, customers who incorporate our products into their products sell a substantial portion of their products outside of the U.S., and all of our products are manufactured outside of the U.S. We are, therefore, subject to many international risks, including, but not limited to:

- increased difficulties in managing international distributors and manufacturers due to varying time zones, languages and business customs;
- foreign currency exchange fluctuations in the currencies of Japan, the People s Republic of China ( PRC ), Taiwan or Korea;
- potentially adverse tax consequences;
- difficulties regarding timing and availability of export and import licenses;
- political and economic instability, particularly in the PRC, Japan, Taiwan, or Korea;
- reduced or limited protection of our IP, particularly in software, which is more prone to design piracy;
- increased transaction costs related to sales transactions conducted outside of the U.S., such as charges to secure letters of credit;
- difficulties in maintaining sales representatives outside of the U.S. that are knowledgeable about our industry and products;
- changes in the regulatory environment in the PRC, Japan, Taiwan and Korea that may significantly impact purchases of our products by our customers;
- outbreaks of SARS, bird flu or other pandemics in the PRC or other parts of Asia; and
- difficulties in collecting outstanding accounts receivable balances.

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

A substantial, and potentially increasing, portion of our products are manufactured by foundries located in the PRC. In addition, a significant percentage of our employees are located in this area. Disruptions from natural disasters, health epidemics (including new outbreaks of SARS or bird flu) and political, social and economic instability may affect the region and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-

Table of Contents

sufficiency, rate of inflation and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to state plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot be assured that the PRC s policies for economic reforms will be consistent or effective. Our results of operations and financial position may be harmed by changes in the PRC s political, economic or social conditions.

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

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

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

We believe our success depends, in large part, upon our ability to identify, attract and retain qualified hardware and software engineers, sales, marketing, finance and managerial personnel. Competition for talented personnel is intense and we may not be able to retain our key personnel or identify, attract or retain other highly qualified personnel in the future. Because of the highly technical nature of our business, the loss of key engineering personnel could delay product introductions and significantly impair our ability to successfully create future products. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenue and business could be seriously harmed.

We have experienced, and may continue to experience, difficulty in hiring and retaining employees with appropriate qualifications. In the last two years a significant portion of our executive management team has turned over, including the Chief Executive Officer, Chief Financial Officer, Vice President of Sales, Vice President of Marketing, Vice President of Business Operations and Vice President, Strategy and Market Development. During 2006 and 2007, we also experienced difficulties hiring and retaining qualified engineers in our Shanghai design center.

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

We contract with third-party foundries for wafer fabrication and other manufacturers for packaging, assembly and testing of our products. We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. Our wafers are fabricated by Semiconductor Manufacturing International Corporation, Taiwan Semiconductor Manufacturing Corporation and Toshiba Corporation. The wafers used in each of our products are fabricated by only one of these manufacturers.

Sole sourcing each product increases our dependence on our suppliers. We have limited control over delivery schedules, quality assurance, manufacturing yields, potential errors in manufacturing and production costs. We do not have long-term supply contracts with our third-party manufacturers or packaging, assembly and testing contractors, so they are not obligated to supply us with products for any specific period of time, quantity or price, except as may be provided in a particular purchase order. From time to time, our suppliers increase

prices charged to produce our products with little notice. If the prices charged by our contract manufacturers increase we may increase our prices, which could harm our competitiveness.

Our requirements represent only a small portion of the total production capacity of our contract manufacturers, who have in the past re-allocated capacity to other customers even during periods of high demand for our products. We expect this may occur again in the future. In addition, the current tightening of credit in financial markets may affect the ability of our suppliers to maintain their production capacity and result in a reduction in the supply of wafers to us. If we are unable to obtain our products from our contract manufacturers on schedule, or at all, our ability to satisfy customer demand will be harmed and revenue from the sale of products may be lost or delayed. If orders for our products are cancelled, expected revenue would not be realized. For example, in the fourth quarter of 2005, one of our contract manufacturers experienced temporary manufacturing delays due to unexpected manufacturing process problems, which caused delays in delivery of our products and made it difficult for us to satisfy our customer demand.

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

Our products require manufacturing with state-of-the-art fabrication equipment and techniques. The lead-time needed to establish a relationship with a new contract manufacturer is at least nine months, and the estimated time for us to adapt a product s design to a particular contract manufacturer s process is at least four months. If we have to qualify a new foundry or packaging, assembly and testing supplier for any of our products, we could incur significant delays in shipping products, which may result in lost revenue and damaged customer relationships.

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

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

***We are dependent on our foundries to implement complex semiconductor technologies and our operations could be adversely affected if those technologies are unavailable, delayed or inefficiently implemented.***

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

implemented.

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

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

Despite testing by both our customers and us, errors or performance problems may be found in existing or new semiconductors. Failure to achieve defect-free products may result in increased costs and delays in the availability of our products. Additionally, customers could seek damages from us for their losses and shipments of defective products may harm our reputation with our customers.

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

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

We are building most of our products on a customer owned tooling basis, also known in the semiconductor industry as COT, where we directly contract the manufacture of wafers and assume the responsibility for the assembly and testing of our products. As a result, we are subject to increased risks arising from wafer manufacturing yields and risks associated with coordination of the manufacturing, assembly and testing process. Poor product yields result in higher product costs, which could make our products uncompetitive if we increased our prices to compensate for our higher costs, or could result in low gross profit margins if we did not increase our prices.

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

From time to time, shortages of materials that are used in our products may occur. In particular, we may experience shortages of semiconductor wafers and packages. If material shortages occur, we may incur additional costs or be unable to ship our products to our customers in a timely fashion, both of which could harm our business and adversely affect our results of operations.

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

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

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

The integration of software with our products adds complexity, may extend our internal development programs and could impact our customers development schedules. This complexity requires increased coordination between hardware and software development schedules and may increase our operating expenses without a

corresponding increase in product revenue. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

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

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

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

Our products are incorporated into our customers products, which have different parts and specifications and utilize multiple protocols that allow them to be compatible with specific computers, video standards and other devices. If our customers products are not compatible with these protocols and standards, consumers will return, or not purchase, these products and the markets for our customers products could be significantly reduced. As a result, a portion of our market would be eliminated, and our business would be harmed.

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

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

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

We may not be able to successfully integrate businesses, products, technologies or personnel of any entity that we might acquire in the future, and any failure to do so could disrupt our business and seriously harm our financial condition. In addition, if we acquire any company with weak internal controls, it will take time to get the acquired company up to a level of operating effectiveness acceptable to us and to implement adequate internal control,

management, financial and operating reporting systems. Our inability to address these risks could negatively affect our operating results.

Table of Contents

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

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

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

- issuance of stock that dilutes current shareholders percentage ownership;
- incurrence of debt;
- assumption of liabilities;
- amortization expenses related to acquired intangible assets;
- impairment of goodwill;
- large and immediate write-offs; or
- decreases in cash and marketable securities that could otherwise serve as working capital.

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

- problems combining the acquired operations, technologies or products;
- unanticipated costs;
- diversion of management s attention from our core business;
- adverse effects on existing business relationships with customers;
- risks associated with entering markets in which we have no or limited prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

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

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

We are spending a significant amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including new Securities and Exchange Commission rules and regulations, NASDAQ Global Market rules and the Sarbanes-Oxley Act of 2002 which requires management s annual review and evaluation of internal control over financial reporting. While we invested significant time and money in our effort to evaluate and test our internal control over financial reporting, a material weakness was identified in our internal control over financial reporting in 2004. Although the material weakness was remediated in the first quarter of 2005, there are inherent limitations to the effectiveness of any system of internal controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future

Table of Contents

events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective controls and procedures can provide only reasonable assurance of achieving their control objectives.

***Environmental laws and regulations have caused us to incur, and may cause us to continue to incur, significant expenditures to comply with applicable laws and regulations, and may cause us to incur significant penalties for noncompliance.***

We are subject to numerous environmental laws and regulations. Compliance with current or future environmental laws and regulations could require us to incur substantial expenses which could harm our business, financial condition and results of operations. For example, during 2006 the European Parliament enacted the Restriction of Hazardous Substances Directive, or RoHS, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead. In 2006, we incurred increased inventory provisions as a result of the enactment of RoHS, which adversely affected our gross profit margin. Additionally during 2006, the European Parliament enacted the Waste Electrical and Electronic Equipment Directive, or WEEE Directive, which makes producers of electrical and electronic equipment financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Additionally, some jurisdictions have begun to require various levels of Electronic Product Environmental Assessment Tool ( EPEAT ) certification, which are based on the Institute of Electrical and Electronics Engineers 1680 standard. The highest levels of EPEAT certification restrict the usage of halogen. Although our older generation products, many of which are still shipping to customers, do contain halogen, our next generation designs do not. We have worked, and will continue to work, with our suppliers and customers to ensure that our products are compliant with enacted laws and regulations. Failure by us or our contract manufacturers to comply with such legislation could result in customers refusing to purchase our products and could subject us to significant monetary penalties in connection with a violation, either of which would have a material adverse effect on our business, financial condition and results of operations. These environmental laws and regulations could become more stringent over time, imposing even greater compliance costs and increasing risks and penalties associated with violations, which could seriously harm our business, financial condition and results of operations. There can be no assurance that violations of environmental laws or regulations will not occur in the future as a result of our inability to obtain permits, human error, equipment failure or other causes.

**Item 1B. Unresolved Staff Comments.**

Not applicable.

Table of Contents

## Item 2. Properties.

We lease facilities around the world to house our engineering, sales, sales support, administrative and operations functions. We do not own any of our facilities, nor do we own or operate a semiconductor fabrication facility. As a result of the restructuring plans we initiated in 2006 and continued to implement throughout 2008, we have consolidated office space and subleased portions of our facilities. At December 31, 2008, our major facilities consisted of the following:

| Location | Function(s) | Total Square Feet Leased | Square Feet Utilized | Square Feet Subleased | Lease Expiration | Sublease Expiration |
|---|---|---|---|---|---|---|
| Oregon | None; vacated December 2008 | 49,000 | | 3,000 | February 2009 | February 2009 |
| Oregon | Administration | 5,000 | 5,000 | | December 2013 | |
| California | Administration; engineering | 37,000 | 23,000 | 14,000 | May 2013 | May 2010 |
| Washington | None; fully subleased | 10,000 | | 10,000 | October 2011 | Various dates through October 2011 |
| China | Engineering; sales; customer support | 46,000 | 46,000 | | November 2009 | |
| Taiwan | Customer support; sales; operations | 16,000 | 16,000 | | Various dates through May 2011 | |
| Japan | Sales; customer support | 4,000 | 4,000 | | January 2011 | |

## Item 3. 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.

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

Not applicable.

# PART II

## Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

### Market for Registrant s Common Equity and Related Stockholder Matters

Our common stock is listed for trading on the NASDAQ Global Market under the symbol PXLW . The stock began trading on May 19, 2000. The following table sets forth, for the periods indicated, the highest and lowest sales prices of our common stock as reported on the NASDAQ Global Market.

| Fiscal 2008 | High | Low |
|---|---|---|
| Fourth Quarter | $ 1.45 | $ 0.55 |
| Third Quarter | 1.90 | 1.08 |
| Second Quarter | 2.95 | 1.53 |
| First Quarter | 2.64 | 1.50 |

| Fiscal 2007 | High | Low |
|---|---|---|
| Fourth Quarter | $ 3.99 | $ 2.25 |
| Third Quarter | 5.67 | 2.43 |
| Second Quarter | 5.28 | 3.96 |
| First Quarter | 7.44 | 4.68 |

As of February 27, 2009, there were 65 shareholders of record (excluding individual participants in securities positions listings), and the last per share sales price of the common stock on that date was $0.54

The payment of dividends is within the discretion of our board of directors and will depend on our earnings, capital requirements and operating and financial condition, among other factors. To date, we have not declared any cash dividends and we currently expect to retain any earnings to finance the expansion and development of our business.

### Securities Authorized for Issuance Under Equity Compensation Plans

Information regarding our equity compensation plans as of December 31, 2008 is disclosed in Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters of this Annual Report on Form 10-K and is incorporated herein by reference from the section titled Information About Our Equity Compensation Plans in our Proxy Statement for our 2009 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Table of Contents

**Issuer Purchases of Equity Securities**

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

| Period | Total number of shares purchased[1] | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Approximate dollar value of shares that may yet be purchased under the plans or programs |
|---|---|---|---|---|
| October 1, 2008 October 31, 2008 | 373,300 | $ 1.04 | 373,300 | $ 3,290 |
| November 1, 2008 November 30, 2008 | 92,800 | 0.93 | 92,800 | 3,204 |
| December 1, 2008 December 31, 2008 | 128,200 | 0.77 | 128,200 | 3,105 |
| Total | 594,300 | $ 0.96 | 594,300 | |

[1] All purchases made on the open market pursuant to the share repurchase program announced in September 2007, under which the board of directors authorized the repurchase of up to $10.0 million of our common stock over the next twelve months. In August 2008, the Board of Directors approved an extension to the program for an additional twelve months, through September 2009. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion. Share repurchases under the program may be made through open market or privately negotiated transactions at our discretion, subject to market conditions and other factors.

Table of Contents

## Performance Graph

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

Set forth below is a graph that compares the cumulative total shareholder return on our common stock with the cumulative total return on the NASDAQ Stock Market (U.S.) Index and the NASDAQ Electronics Components Index over the five-year period ended December 31, 2008. Measurement points are the market close on the last trading day of each of our fiscal years ended December 31, 2003, December 31, 2004, December 31, 2005, December 31, 2006, December 31, 2007 and December 31, 2008. The graph assumes that $100 was invested on December 31, 2003 in our common stock, the NASDAQ Stock Market (U.S.) Index and the NASDAQ Electronics Components Index. In accordance with guidelines of the Securities and Exchange Commission, the shareholder return for each entity in the peer group index has been weighted on the basis of market capitalization. The stock price performance in the graph is not intended to forecast or indicate future stock price performance.

**COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN AMONG PIXELWORKS, INC., THE NASDAQ STOCK MARKET (U.S.) INDEX AND THE NASDAQ ELECTRONICS COMPONENTS INDEX**

Table of Contents

**Item 6. Selected Financial Data.**

The following consolidated selected financial data should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation and Item 8. Financial Statements and Supplementary Data.

Statement of Operations Data

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (In thousands, except per share data) | | | | |
| Revenue, net | $ 85,164 | $ 105,980 | $ 133,607 | $ 171,704 | $ 176,211 |
| Cost of revenue | 42,963 | 59,273 | 107,506 | 108,748 | 90,991 |
| Gross profit | 42,201 | 46,707 | 26,101 | 62,956 | 85,220 |
| Operating expenses: | | | | | |
| Research and development | 26,512 | 38,792 | 57,019 | 51,814 | 32,969 |
| Selling, general and administrative | 17,945 | 25,437 | 35,053 | 30,616 | 23,736 |
| Restructuring | 1,589 | 13,285 | 13,316 | 1,162 | |
| Amortization of acquired intangible assets | 164 | 359 | 602 | 1,084 | 486 |
| Impairment loss on goodwill | | | 133,739 | | |
| Impairment loss on acquired intangible assets | | | 1,753 | | |
| Total operating expenses | 46,210 | 77,873 | 241,482 | 84,676 | 57,191 |
| Income (loss) from operations | (4,009) | (31,166) | (215,381) | (21,720) | 28,029 |
| Interest and other income, net | 11,979 | 2,483 | 10,254 | 1,532 | 1,742 |
| Income (loss) before income taxes | 7,970 | (28,683) | (205,127) | (20,188) | 29,771 |
| Provision (benefit) for income taxes | (8) | 2,237 | (949) | 22,422 | 7,990 |
| Net income (loss) | $ 7,978 | $ (30,920) | $ (204,178) | $ (42,610) | $ 21,781 |
| Net income (loss) per share: | | | | | |
| Basic | $ 0.55 | $ (1.92) | $ (12.69) | $ (2.70) | $ 1.40 |
| Diluted | $ 0.55 | $ (1.92) | $ (12.69) | $ (2.70) | $ 1.35 |
| Weighted average shares outstanding: | | | | | |
| Basic | 14,399 | 16,069 | 16,096 | 15,779 | 15,558 |

| Diluted | 14,410 | 16,069 | 16,096 | 15,779 | 17,354 |
|---|---|---|---|---|---|

Table of Contents

Balance Sheet Data

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (In thousands) | | | | |
| Cash and cash equivalents | $ 53,149 | $ 74,572 | $ 63,095 | $ 68,604 | $ 32,585 |
| Short- and long-term marketable securities | 10,168 | 44,385 | 71,489 | 77,033 | 239,696 |
| Working capital | 61,947 | 112,360 | 108,169 | 139,291 | 209,653 |
| Total assets | 91,732 | 161,916 | 207,771 | 421,556 | 423,569 |
| Long-term liabilities, net of current portion | 73,250 | 151,871 | 147,414 | 163,357 | 150,365 |
| Total shareholders equity (deficit) | 4,711 | (8,027) | 21,948 | 215,217 | 252,023 |

**Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation.**

**Overview**

We are an innovative designer, developer and marketer of video and pixel processing semiconductors and software for high-end digital video applications. Our solutions enable manufacturers of digital display and projection devices, such as large-screen liquid crystal displays ( LCDs ) and digital front projectors, to differentiate their products with a consistently high level of video quality, regardless of the content s source or format. Our core technology leverages unique proprietary techniques for intelligently processing video signals from a variety of sources to ensure that all resulting images are optimized. Additionally, our products help our customers reduce costs and differentiate their display and projection devices, an important factor in industries that experience rapid innovation. Pixelworks flexible design architecture enables our technology to produce outstanding image quality in our customers display and projection products with a range of integrated circuit ( IC ) and software solutions. Pixelworks was founded in 1997 and is incorporated under the laws of the state of Oregon.

Over the course of the last several years, the display and projection industries have moved rapidly from analog technology, which utilizes waveform signals, to a new generation of digital technologies that utilize a grid of thousands of tiny picture elements, or pixels. Digital technology is rapidly evolving to incorporate higher pixel counts and faster rates of screen refresh, both of which contribute to a sharper, clearer image. Accordingly, the video image processors that drive newer displays have had to increase their capabilities as well to keep pace with the ever growing needs for greater resolution, size and speed that digital technology affords.

Pixelworks has an array of proprietary technologies and advanced designs to address the requirements of diverse high-end digital video devices, from digital projectors to large screen LCD displays. Our products range from single-purpose ICs, to system-on-chip ( SoC ) ICs that integrate microprocessor, memory and image processing functions. Additionally, we provide full solutions, including a complete software development environment and operating system, which enable our customers to rapidly develop and customize their display products, thus reducing their time to market and enabling them to incorporate differentiated features and functions. During 2008 we focused on developing products that provide additional functionality and utilize more advanced processes in order to improve performance and lower product costs. We continually expand our technology portfolio through internal developments, acquisitions and co-developments with business partners.

We have adopted a product strategy that leverages our core competencies in video processing to address the evolving needs of the advanced flat panel display, digital projection and other markets that require superior image quality. We focus our product investments on developing video enhancement solutions for these markets, with particular focus on

adding increased performance and functionality. Additionally, we look for ways to leverage our research and development investment into products that address other high-value markets where our innovative proprietary technology provides differentiation for us and our customers.

Historically, significant portions of our revenue have been generated by sales to a relatively small number of end customers and distributors. We sell our products worldwide through a direct sales force and indirectly

through distributors and manufacturers representatives. We sell to distributors in Japan, China, Europe and the U.S, and our manufacturers representatives support some of our European and Korean sales. Sales to distributors represented 53%, 57%, and 52% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Sales to Tokyo Electron Device, Ltd. ( TED ), our Japanese distributor, represented 32%, 33% and 26% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Sales to Seiko Epson Corporation, our top end customer, represented 24%, 21% and 15% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Our distributors typically provide engineering support to our end customers and often have valuable and established relationships with our end customers. In certain countries it is customary to sell to distributors. While distributor payment to us is not dependent upon the distributor s ability to resell the product or to collect from the end customer, the distributors may provide longer payment terms to end customers than those we would offer.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for approximately 95% of revenue for the year ended December 31, 2008 and 96% for the years ended December 31, 2007 and 2006. Our integrators, branded manufacturers and branded suppliers incorporate our products into systems that are sold worldwide. All of our revenue to date has been denominated in U.S. dollars.

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

*General Market Conditions*

Economic conditions in the United States and in foreign markets in which we operate substantially affect our sales and profitability. Economic activity in the United States and throughout much of the world has undergone a sudden, sharp downturn. Global credit and capital markets have experienced unprecedented volatility and disruption and business credit and liquidity have tightened in much of the world. Some of our suppliers and customers may face credit issues and could experience cash flow problems and other financial hardships. Consumer confidence and spending are down significantly and we expect weaker demand from our customers to persist into 2009. These trends are expected to adversely impact our business, results of operations and financial position and we are unable to forecast when or if these conditions will improve.

*Restructuring Plans*

In December 2008, we initiated a restructuring plan to reduce our operating expenses in response to decreases in current and forecasted revenue. The plan will reduce operations, research and development and administrative headcount in our San Jose, Taiwan and China offices, and we expect the plan to be substantially complete in the first quarter of 2009. We will continue to monitor and evaluate the need for additional restructuring actions in light of global economic uncertainty and its potential impact on our continuing business. While the need for additional restructuring actions in response to decreased revenue is being evaluated, uncertainty regarding the outlook for 2009 and beyond impedes our ability to forecast the scope and impact of any potential actions.

In November 2006, we initiated a restructuring plan to reduce operating expenses and continued to implement this plan throughout 2007 and 2008. This plan included consolidation of our operations in order to reduce compensation and rent expense, while at the same time making critical infrastructure investments in people, processes and information systems to improve our operating efficiency. As part of this plan we closed offices in Toronto, Beijing and Shenzhen. Additionally, we eliminated all operations and research and development activities at our Tualatin location and transferred them to our offices in San Jose, Shanghai and Hsin Chu. The consolidation and closure of these offices and reduction in headcount resulted in charges for non-cancelable leases and termination and retention benefits for effected employees. In connection with this restructuring, we also narrowed and redefined our product development strategy which resulted in the write-off of IP assets, tooling, software development tools and charges for related non-cancelable contracts. This plan was completed during the fourth quarter of 2008.

In April 2006, we initiated a restructuring plan to reduce our breakeven point by decreasing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol Television ( IPTV ) technology that we acquired from Equator Technologies, Inc. ( Equator ) with

our advanced television technology developments and no longer pursuing stand-alone advanced media processor markets. We also consolidated our two California offices as part of this plan, which was completed during the fourth quarter of 2006.

*Goodwill and Intangible Asset Impairments*

During 2006, we performed impairment analyses on the intangible assets that we acquired from Equator and on our goodwill. In the first quarter of 2006, we recorded an impairment loss of $23.1 million on the acquired intangible assets. This impairment loss represented the excess of the carrying amount over the estimated fair value of the intangible assets. In the second quarter of 2006, we recorded an impairment loss of $133.7 million on goodwill. This impairment loss represented the excess carrying amount of the goodwill over the implied fair value of the goodwill.

**Results of Operations**

*Year ended December 31, 2008 compared with year ended December 31, 2007, and year ended December 31, 2007 compared with year ended December 31, 2006.*

Revenue, net

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

| | Year Ended December 31, | | | 2008 v. 2007 | | 2007 v. 2006 | |
|---|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | $ change | % change | $ change | % change |
| Digital projector | $ 52,926 | $ 58,674 | $ 59,236 | $ (5,748) | (10)% | $ (562) | (1)% |
| Advanced television | 11,177 | 19,827 | 43,221 | (8,650) | (44) | (23,394) | (54) |
| Advanced media processor | 11,342 | 16,098 | 18,135 | (4,756) | (30) | (2,037) | (11) |
| LCD monitor, panel and other | 9,719 | 11,381 | 13,015 | (1,662) | (15) | (1,634) | (13) |
| Total revenue | $ 85,164 | $ 105,980 | $ 133,607 | $ (20,816) | (20)% | $ (27,627) | (21)% |

Net revenue decreased $20.8 million, or 20%, from 2007 to 2008 and decreased $27.6 million, or 21%, from 2006 to 2007. The decrease from 2007 to 2008 resulted from a 26% decrease in units sold, partially offset by a 9% increase in average selling price ( ASP ). The decrease from 2006 to 2007 resulted from a 29% decrease in units sold, partially offset by an 11% increase in ASP. The increase in ASP from 2007 to 2008 and from 2006 to 2007 was primarily the result of an increase in the percentage of total revenue from the digital projector market, which generally has higher ASPs than our other products.

*Digital Projector*

Revenue from the digital projector market decreased 10% from 2007 to 2008 and decreased 1% from 2006 to 2007. The decrease in revenue from 2007 to 2008 resulted from a general weakening of the market, particularly during the fourth quarter of 2008 as our customers decreased their inventory levels due to macroeconomic uncertainty. Units sold and ASP in the digital projector market decreased 8% and 2%, respectively, from 2007 to 2008, and decreased 3% and

increased 2%, respectively, from 2006 to 2007.

*Advanced Television*

Revenue from the advanced television market decreased 44% from 2007 to 2008 and 54% from 2006 to 2007. These decreases were primarily attributable to our decision to shift our focus away from the commoditized SoC segment of the advanced television market. With our new strategy we are developing co-processor ICs that will improve the video performance of any image processor in the large screen, high-resolution, high quality segment of the advanced television market. Units sold and ASP in the advanced television market decreased 54% and increased 22%, respectively, from 2007 to 2008 and decreased 52% and 4%, respectively,

Table of Contents

from 2006 to 2007. The increase in ASP from 2007 to 2008 was primarily due to a decrease in the percentage of our advanced television sales attributable to legacy CRT products.

*Advanced Media Processor*

Revenue in the advanced media processor market resulted from our acquisition of Equator in June 2005. Revenue from this market decreased 30% from 2007 to 2008 and decreased 11% from 2006 to 2007. The decrease from 2007 to 2008 was primarily attributable to a 40% decrease in units shipped, partially offset by a 17% increase in ASP. The increase in ASP from 2007 to 2008 is primarily due to a change in our customer mix. The decrease from 2006 to 2007 was primarily attributable to a 16% decrease in ASP, partially offset by a 6% increase in units sold.

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

*LCD Monitor, Panel and Other*

LCD monitor, panel and other revenue decreased 15% from 2007 to 2008 and decreased 13% from 2006 to 2007. These decreases are primarily attributable to our decision to stop focusing our development efforts on the SoC LCD monitor market.

Cost of revenue and gross profit

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

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | **2008** | **% of revenue** | **2007** | **% of revenue** | **2006** | **% of revenue** |
| Direct product costs and related overhead [1] | $ 39,362 | 46% | $ 53,807 | 51% | $ 73,900 | 55% |
| Amortization of acquired intangible assets | 2,820 | 3 | 2,820 | 3 | 4,087 | 3 |
| Provision for obsolete inventory, net of usage | 488 | 1 | 2,376 | 2 | 5,836 | 4 |
| Restructuring | 91 | 0 | 172 | | 2,119 | 2 |
| Stock-based compensation | 58 | 0 | 98 | | 208 | |
| Additional amortization of non-cancelable prepaid royalty | 144 | 0 | | | | |
| Impairment loss on acquired developed technology | | | | | 21,330 | 16 |
| Amortization of acquired inventory markup | | | | | 26 | 0 |
| Total cost of revenue | $ 42,963 | 50% | $ 59,273 | 56% | $ 107,506 | 80% |
| Gross profit | $ 42,201 | 50% | $ 46,707 | 44% | $ 26,101 | 20% |

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

Direct product costs and related overhead decreased to 46% of total revenue in 2008 from 51% of total revenue in 2007 and 55% of total revenue in 2006. These decreases resulted primarily from a more favorable mix of products sold, lower pricing obtained from vendors, and increases in production yields.

The net provision for obsolete inventory decreased to 1% of revenue in 2008 from 2% in 2007 and 4% in 2006. The decrease in the net provision for obsolete inventory as a percentage of revenue in 2008 compared to 2007 is attributable to our increased focus on inventory management. The decrease in the net provision for obsolete inventory from 2006 to 2007 was partially due to regulations imposed in 2006 by the European Union s Restriction of Hazardous Substances ( RoHS ) Directive, which prevents us from selling parts containing specific hazardous substances such as lead to certain of our customers.

Table of Contents

Research and development

Research and development expense includes compensation and related costs for personnel, development-related expenses including non-recurring engineering and fees for outside services, depreciation and amortization, expensed equipment, facilities and information technology expense allocations and travel and related expenses. Research and development expense was as follows (in thousands):

| | Year ended December 31, | | | 2008 v. 2007 | | 2007 v. 2006 | |
|---|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | $ change | % change | $ change | % change |
| Research and development [1] | $ 26,512 | $ 38,792 | $ 57,019 | $ (12,280) | (32)% | $ (18,227) | (32)% |
| [1] Includes stock-based compensation expense of: | 1,250 | 2,320 | 3,884 | | | | |

Research and development expense decreased $12.3 million, or 32%, from 2007 to 2008. This decrease is directly attributable to the restructuring efforts that we initiated in 2006 and continued to implement throughout 2008. These efforts are focused on returning the Company to profitability and resulted in the following reductions in research and development expenses:

Depreciation and amortization expense, software maintenance expense and expensed equipment and software decreased $6.4 million. This decrease is primarily due to the December 31, 2007 write-off of engineering software tools, which we are no longer using due to reductions in research and development personnel and changes in product development strategy.

Compensation expense decreased $2.6 million. The decrease in compensation expense in 2008 is primarily due to headcount reductions that occurred in the second half of 2007. At December 31, 2008, we had 130 research and development employees compared to 146 at December 31, 2007.

Facilities and information technology expense allocations decreased $1.7 million, primarily due to reductions in headcount, outsourced IT support, lower rent and decreased equipment depreciation.

Stock-based compensation expense decreased $1.1 million due to personnel reductions and reduced valuation of our stock options.

Travel and related expenses decreased $656,000.

Research and development expense decreased $18.2 million, or 32%, from 2006 to 2007. This decrease was primarily due to the following factors:

Compensation expense decreased $6.4 million. At December 31, 2007, we had 146 research and development employees compared to 254 at December 31, 2006.

Development-related expenses, including non-recurring engineering and outside services, decreased $4.7 million.

Depreciation and amortization expense, software maintenance expense and expensed equipment and software decreased $2.5 million.

Facilities and information technology expense allocations decreased $1.9 million, primarily due to lower rent expense.

Stock-based compensation expense decreased $1.6 million.

Travel and related expenses decreased $730,000.

Selling, general and administrative

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

Table of Contents

and administrative support functions. Selling, general and administrative expense was as follows (in thousands):

| | Year ended December 31, | | | 2008 v. 2007 | | 2007 v. 2006 | |
|---|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | $ change | % change | $ change | % change |
| Selling, general and administrative [1] | $ 17,945 | $ 25,437 | $ 35,053 | $ (7,492) | (29)% | $ (9,616) | (27)% |
| [1] Includes stock-based compensation expense of: | 1,198 | 3,527 | 5,464 | | | | |

Selling, general and administrative expense decreased $7.5 million, or 29%, from 2007 to 2008. The decrease in selling, general and administrative expense from 2007 to 2008 is primarily attributable to the restructuring efforts that we initiated in 2006 and continued to implement throughout 2008. These efforts are focused on returning the Company to profitability and resulted in the following reductions in selling, general and administrative expenses:

Compensation expense decreased $3.3 million. The decrease in compensation expense in 2008 is primarily due to significant headcount reductions that occurred in the second half of 2007, partially off-set by headcount increases in the second half of 2008. As of December 31, 2008, we had 74 employees in selling, general and administrative functions, compared to 69 as of December 31, 2007.

Stock-based compensation expense decreased $2.3 million due to personnel reductions and reduced valuation of our stock options.

Facilities and information technology allocations decreased $689,000, primarily due to reductions in headcount, outsourced IT support, lower rent and decreased equipment depreciation.

Travel and related expenses decreased $530,000.

Selling, general and administrative expense decreased $9.6 million, or 27%, from 2006 to 2007. This decrease includes a $533,000 decrease in sales commissions which resulted from lower revenue in 2007 compared to 2006, and a decrease in exchange loss of $729,000 which resulted primarily from exchange gains on cash and marketable securities held in Canadian dollars.

The remainder of the decrease in selling, general and administrative expense from 2006 to 2007 is primarily attributable to the restructuring efforts that we initiated in 2006, which resulted in the following reductions:

Compensation expense decreased $3.6 million. As of December 31, 2007, we had 69 employees in selling, general and administrative functions, compared to 150 as of December 31, 2006.

Stock-based compensation expense decreased $1.9 million.

Facilities and information technology allocations decreased $727,000.

Travel and related expenses decreased $592,000.

Depreciation and amortization expense, software maintenance expense and expensed equipment and software decreased $442,000.

Professional service fees, including accounting and legal, decreased $376,000.

Table of Contents

Restructuring

*Year Ended December 31, 2008*

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

| | Dec. 08 Plan | | Nov. 06 Plan | | Total | |
|---|---|---|---|---|---|---|
| Termination and retention benefits [1] | $ | 666 | $ | 506 | $ | 1,172 |
| Consolidation of leased space [2] | | | | 508 | | 508 |
| Total restructuring expenses | $ | 666 | $ | 1,014 | $ | 1,680 |
| Included in cost of sales | $ | 91 | $ | | $ | 91 |
| Included in operating expenses | | 575 | | 1,014 | | 1,589 |

[1] Termination and retention benefits included severance and retention payments for terminated employees and retention payments for certain continuing employees.

[2] Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and moving expenses.

December 2008 plan: In December 2008, we initiated a restructuring plan to reduce our operating expenses in response to decreases in current and forecasted revenue which resulted from global economic uncertainty. The plan will reduce operations, research and development and administrative headcount in our San Jose, Taiwan and China offices, and will be substantially complete in the first quarter of 2009. We anticipate that the specific actions described will reduce our compensation expense by approximately 10% by the third quarter of 2009, with the majority of the expense reductions beginning in the first quarter of 2009. We will continue to monitor and evaluate the need for additional restructuring actions in light of global economic uncertainty and its potential impact on our continuing business. While the need for additional restructuring actions in response to decreased revenue is being evaluated, uncertainty regarding the outlook for 2009 and beyond impedes our ability to forecast the scope and impact of any potential actions.

November 2006 plan: In November 2006, we initiated a restructuring plan that included consolidation of our operations in order to reduce compensation and rent expense, while at the same time making critical infrastructure investments in people, processes and information systems to improve our operating efficiency. This plan was completed in the fourth quarter of 2008. Activities undertaken in 2008 related to this plan included completing the closure of our Toronto office. We also incurred additional expenses for termination and retention benefits and consolidation of leased space related to specific actions initiated in prior years. The expected benefits from this restructuring plan are fully reflected in our business outlook for the first quarter of 2009, which is presented below.

*Year Ended December 31, 2007*

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

| | Nov. 06 Plan |
|---|---|

| | | |
|---|---|---|
| Termination and retention benefits [1] | $ | 5,420 |
| Net write-off of assets and reversal of related liabilities [2] | | 3,905 |
| Contract termination fee [3] | | 1,693 |
| Payments, non-cancelable contracts [4] | | 1,524 |
| Consolidation of leased space [5] | | 827 |
| Other | | 88 |
| Total restructuring expenses | $ | 13,457 |
| Included in cost of sales | $ | 172 |
| Included in operating expenses | | 13,285 |

[1] Termination and retention benefits included severance and retention payments for terminated employees and retention payments for certain continuing employees.

[2] We wrote off assets with a net book value of $6.9 million in 2007 as a result of our November 2006 restructuring plan. These assets consisted primarily of engineering software tools which we are no longer using due to the reductions in research and development personnel and changes in product development strategy. We also reversed accrued liabilities in the amount of $3.0 million related to the write-off of the engineering software tools.

[3] We paid a contract termination fee of $1.7 million to cancel a software license agreement prior to its expiration.

[4] Non-cancelable contract payments consist of amounts that we were obligated to pay, but for which we will not realize a benefit due to the restructuring plans.

[5] Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and moving expenses.

All of our 2007 restructuring expense was attributable to our November 2006 restructuring plan. In 2007, we closed our offices in Beijing and Shenzhen and significantly reduced research and development activities at our Toronto office. Additionally, during 2007 substantially all of the operations and research and development activities of our Tualatin location were transferred to our offices in San Jose, Shanghai and Hsin Chu. The consolidation and closure of these offices and reduction in headcount resulted in charges for non-cancelable leases and termination and retention benefits for effected employees. In connection with this restructuring we also narrowed and redefined our product development strategy which resulted in the write-off of IP assets, tooling, software development tools and charges for related non-cancelable contracts.

*Year Ended December 31, 2006*

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

| | Nov. 06 Plan | | Apr. 06 Plan | | Total | |
|---|---|---|---|---|---|---|
| Net write-off of assets and reversal of related liabilities [1] | $ | 11,391 | $ | 227 | $ | 11,618 |
| Termination and retention benefits [2] | | 1,423 | | 1,358 | | 2,781 |
| Consolidation of leased space [3] | | | | 1,036 | | 1,036 |
| Total restructuring expenses | $ | 12,814 | $ | 2,621 | $ | 15,435 |
| Included in cost of sales | $ | 2,119 | $ | | $ | 2,119 |
| Included in operating expenses | | 10,695 | | 2,621 | | 13,316 |

[1] We wrote off assets with a net book value of $11.6 million in 2006 as a result of our restructuring plans. These assets consisted primarily of licensed technology and tooling.

[2] Termination and retention benefits included severance and retention payments for terminated employees and retention payments for certain continuing employees.

[3] Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and moving expenses.

November 2006 plan: In November 2006, we initiated a restructuring plan that included consolidation of our operations in order to reduce compensation and rent expense, while at the same time making critical infrastructure investments in people, processes and information systems to improve our operating efficiency. Activities undertaken in 2006 related to this plan included beginning the transfer of the operations and research and development activities of our Tualatin location to our offices in San Jose, Shanghai and Hsin Chu. The reduction in headcount resulted in expenses for termination and retention benefits for effected employees. In connection with this restructuring we also narrowed and redefined our product development strategy, resulting in the write-off of IP assets and tooling.

April 2006 plan: In April 2006, we initiated a restructuring plan to reduce our breakeven point by decreasing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol Television ( IPTV ) technology that we acquired from Equator Technologies, Inc. ( Equator ) with our advanced television technology developments and no longer pursuing stand-alone

Table of Contents

advanced media processor markets. We also consolidated our two California offices as part of this plan, which was completed during the fourth quarter of 2006.

Amortization of acquired intangible assets

Amortization of acquired intangible assets was as follows (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Amortization of acquired intangible assets | $ 164 | $ 359 | $ 602 |

We recorded a customer relationship intangible asset and a trademark intangible asset in connection with the acquisition of Equator in June 2005. As of December 31, 2008, the customer relationship intangible asset was fully amortized and as of December 31, 2006, the trademark intangible asset was fully amortized.

Interest and other income, net

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

| | Year ended December 31, | | | $ change | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2008 v. 2007 | 2007 v. 2006 |
| Gain on repurchase of long-term debt, net [1] | $ 19,670 | $ | $ 3,009 | $ 19,670 | $ (3,009) |
| Other-than-temporary impairment of marketable security, net [2] | (7,890) | | | (7,890) | |
| Interest income [3] | 2,102 | 5,786 | 5,833 | (3,684) | (47) |
| Interest expense [4] | (1,695) | (2,642) | (2,721) | 947 | 79 |
| Amortization of debt issuance costs [5] | (426) | (661) | (667) | 235 | 6 |
| Settlement proceeds, net [6] | | | 4,800 | | (4,800) |
| Other income [7] | 218 | | | 218 | |
| Total interest and other income, net | $ 11,979 | $ 2,483 | $ 10,254 | $ 9,496 | $ (7,771) |

1 In August 2008, we repurchased and retired $29.1 million of our outstanding debt for $20.6 million in cash. We recognized a gain on this repurchase of $8.1 million, net of a write-off of debt issuance costs of $390,000. In February 2008, we repurchased and retired $50.2 million of our outstanding debt for $37.9 million in cash, including legal and other professional fees of $755,000. We recognized a gain on this repurchase of $11.6 million, net of a write-off of debt issuance costs of $752,000. In February 2006, we repurchased and retired $10.0 million of our outstanding debt for $6.8 million in cash. We recognized a gain on this repurchase of $3.0 million, net of a write-off of debt issuance costs of $191,000.

2 In the first quarter of 2008, we recognized an other-than-temporary impairment of $6.5 million on an investment in a publicly-traded equity security, due to the duration of time that the investment had been below cost, as well as

decreased target price estimates, analyst downgrades and macroeconomic factors. In the fourth quarter of 2008, we recognized a second other-than-temporary impairment of $1.4 million on the same investment, based on the same factors considered in our March 31, 2008 analysis.

[3] Interest income is earned on cash equivalents and short- and long-term marketable securities. The decrease in the 2008 period is due to lower balances of marketable securities, which resulted from our repurchases of long-term debt and decreased yields on our invested funds.

[4] Interest expense primarily relates to interest payable on our long-term debt. The decrease in the 2008 period is due to the reduced outstanding principal balance which resulted from our 2008 repurchases of our long-term debt.

[5] The fees associated with the issuance of our long-term debt have been capitalized and are being amortized over a period of seven years. The remaining amortization period is approximately two years as of December 31, 2008. The decrease in the 2008 period is due to the write-off of fees associated with the portion of our long-term debt repurchased in 2008.

[6] During the fourth quarter of 2006, our claim against funds placed in escrow in connection with the Equator acquisition was settled. In the settlement, we received proceeds of $4.8 million net of legal fees.

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

Provision (benefit) for income taxes

The provision (benefit) for income taxes was as follows (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | **2008** | **2007** | **2006** |
| Provision (benefit) for income taxes | $ (8) | $ 2,237 | $ (949) |

The income tax benefit recorded for the year ended December 31, 2008 is comprised of current and deferred tax expense in profitable foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions, off set by a benefit of $866,000 for refundable research and experimentation credits and a benefit of $559,000 for the reversal of a previously recorded tax contingency due to the expiration of the applicable statute of limitations. The income tax provision recorded for the year ended December 31, 2007 is comprised of current and deferred tax expense in profitable foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. The income tax benefit recorded for the year ended December 31, 2006 resulted primarily from an income tax refund that was received through a net operating loss carryback to a prior year, plus the recognition of deferred tax assets in foreign jurisdictions. These benefits were partially offset by current tax in foreign jurisdictions and accruals for foreign tax contingencies.

At December 31, 2008, we continued to provide a full valuation allowance against our U.S. and Canadian deferred tax assets as we do not believe that it is more likely than not that we will realize a benefit from those assets. We did not record a valuation allowance against our foreign deferred tax assets as we believe that it is more likely than not that we will realize a benefit from those assets.

As of December 31, 2008, we have generated deductible temporary differences and net operating loss and tax credit carryforwards. We have federal, state and foreign net operating loss carryforwards of approximately $180.4 million, $89.9 million and $7.9 million, respectively, and federal, state and foreign research and experimentation tax credit carryforwards of approximately $6.8 million, $3.9 million and $2.2 million, respectively. General foreign tax credits were $2.0 million at December 31, 2008. The carryforwards begin expiring in 2009.

Utilization of a portion of the net operating loss and credit carryforwards is subject to an annual limitation due to the ownership change provisions of the Internal Revenue Code of 1986, as amended, and similar state provisions. An ownership change subject to these provisions occurred for nDSP in 2002 and Equator in 2005 when we acquired these entities.

Business Outlook

On January 29, 2009, we provided an outlook for the first quarter of 2009 in our earnings release, which was furnished on a current report on Form 8-K. The outlook provided the following anticipated financial results prepared in accordance with U.S. generally accepted accounting principles:

We expect to record net loss per share in the first quarter of 2009 of $(0.22) to $(0.42), based on the following estimates:

First quarter revenue of $10.0 million to $13.0 million.

Gross profit margin of approximately 35% to 40%.

Operating expenses of $9.5 million to $10.5 million.

Interest expense, net of approximately $200,000.

A benefit for income tax of approximately $1.5 million.

**Liquidity and Capital Resources**

Cash and short- and long-term marketable securities

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

| | December 31, | | | % Change | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2008 v. 2007 | 2007 v. 2006 |
| Cash and cash equivalents | $ 53,149 | $ 74,572 | $ 63,095 | (29)% | 18% |
| Short-term marketable securities | 8,058 | 34,581 | 53,985 | (77) | (36) |
| Long-term marketable securities | 2,110 | 9,804 | 17,504 | (78) | (44) |
| Total cash and marketable securities | $ 63,317 | $ 118,957 | $ 134,584 | (47)% | (12)% |

Total cash and marketable securities decreased 47% from 2007 to 2008. The decrease resulted primarily from $58.6 million used for the repurchase of long-term debt, $4.6 million in payments on property and equipment and other asset financing, $2.6 million used for the repurchase of our common stock and $2.2 million used for purchases of property and equipment and other long-term assets. The decreases were partially offset by $15.0 million of positive cash flow from operations.

Total cash and marketable securities decreased 12% from 2006 to 2007. This decrease resulted primarily from an increase in working capital excluding cash and marketable securities, $3.2 million in purchases of property and equipment and other long-term assets, $6.7 million in payments on property and equipment and other asset financing, and $4.3 million used for the repurchase of our common stock.

At December 31, 2008, cash equivalents and short-term marketable securities included $34.2 million in money market funds, $3.5 million in commercial paper, $3.6 million in U.S. government agencies debt securities, and $1.0 million in corporate debt securities. At December 31, 2008, we also held a $2.1 million long-term strategic equity investment in a publicly traded corporation. All of our investments were denominated in U.S. dollars, and our portfolio did not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral.

The quality of our short-term investment portfolio remains high during this difficult credit environment. Our investment policy requires that at least 25% of our portfolio matures within 90 days. Additionally, no maturities can extend beyond one year and concentrations with individual securities are limited. Investments must be rated at least A-1 / P-1 by Standard & Poor s / Moody s, and our investment policy is reviewed at least annually by our Audit Committee.

The valuations of our short-term marketable securities are affected by a variety of factors, including changes in interest rates and the actual or perceived financial stability of the issuer. However, due to the high quality of our investments and their short-term nature, there has not been, and we do not expect there to be, a significant fluctuation in the valuation of these investments. Accordingly, we do not expect a materially negative impact on our financial condition from fluctuations in the value of our short-term investments. As of December 31, 2008, we had a total unrealized gain of $125,000 on these investments.

The valuation of our long-term equity investment has fluctuated significantly, and could continue to fluctuate significantly, due to a variety of factors including changes in the global economy and changes in the actual or expected performance of the issuing company. We recorded other-than-temporary impairments related to this investment of $6.5 million and $1.4 million in the first and fourth quarter of 2008, respectively. We may record additional impairment charges in the future if we determine that further declines in value of the investment are other-than-temporary. Such an impairment would negatively impact our results of operations, but would not materially impact our financial condition.

When available, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our cash equivalents and marketable securities. If quoted prices in active markets for identical assets or liabilities are not available, we use quoted prices for similar assets or liabilities, or use observable inputs other than the quoted prices, to determine fair value. We have no investments which are fair valued based on unobservable inputs.

We anticipate that our existing cash and investment balances will be adequate to fund our operating and investing needs for the next twelve months. From time to time, we may evaluate acquisitions of businesses, products or technologies that complement our business. We may also repurchase additional amounts of our long-term debt and common stock, as we did during the first quarter of 2009, and as described below under capital resources. Any further transactions, if consummated, may consume a material portion of our working capital or require the issuance of equity securities that may result in dilution to existing shareholders.

Accounts receivable, net

Accounts receivable, net decreased to $6.1 million at December 31, 2008 from $6.2 million at December 31, 2007. Average number of days sales outstanding increased to 29 days at December 31, 2008 from 21 days at December 31, 2007.

Inventories, net

Inventories, net decreased to $5.0 million at December 31, 2008 from $11.3 million at December 31, 2007. Inventory turnover on an annualized basis increased to 7.0 at December 31, 2008 from 3.9 at December 31, 2007. As of December 31, 2008, this represented approximately nine weeks of inventory on hand. The decrease in inventory and increase in turnover are due to our focus on close inventory management.

Capital resources

In 2004, we issued $150.0 million of 1.75% convertible subordinated debentures (the debentures ) due 2024. In February 2006, we repurchased and retired $10.0 million of the debentures. In February 2008, we repurchased and retired $50.2 million principal amount of the debentures through a modified dutch auction tender offer for $37.9 million in cash. We recognized a net gain of $11.6 million on the repurchase, which included a $13.1 million discount, offset by legal and professional fees of $755,000 and a write-off of debt issuance costs of $752,000. In August 2008, we repurchased and retired $29.1 million of the debentures for $20.6 million in cash. We recognized a net gain of $8.1 million on the repurchase, which included an $8.5 million discount, offset by a write-off of debt issuance costs of $390,000. In February 2009, we repurchased and retired $27.1 million of the debentures for $17.8 million in cash in a private transaction, reducing the balance of our outstanding debentures to $33.5 million. As a result of this transaction, we will recognize a net gain on the repurchase of $9.0 million, which includes a $9.3 million discount, offset by write-offs of debt issuance costs of $288,000 and other fees of $34,000.

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

In September 2007, the Board of Directors authorized the repurchase of up to $10.0 million of our common stock over the next twelve months. In August 2008, the Board of Directors approved an extension to the program for an additional twelve months, through September 2009. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion. Share repurchases under the program may be made through open market and privately negotiated transactions at our discretion, subject to market conditions and other factors. During 2008, we repurchased 1,625,737 shares for $2.6 million and we repurchased 1,260,833 common shares at a cost of $4.3 million during 2007. As of December 31, 2008, $3.1 million remained available for repurchase under the plan. Between January 1, 2009 and February 28, 2009 we repurchased an

additional 228,600 shares for $167,000. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

### Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and judgments that affect the amounts reported. On an ongoing basis, we evaluate our estimates, including those related to product returns, warranty obligations, bad debts, inventories, property and equipment, intangible assets, impairment of long-lived assets, valuation of investments, amortization of prepaid royalties, valuation of share-based payments, income taxes, litigation and other contingencies. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue Recognition.* We recognize revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition*. Accordingly, revenue is recognized when an authorized purchase order has been received, title and risk of loss have transferred, the sales price is fixed or determinable, and collectibility of the receivable is reasonably assured. This generally occurs upon shipment of the underlying product.

*Sales Returns and Allowances.* Our customers do not have a stated right to return product except for replacement of defective products under our warranty program discussed below. However, we have accepted customer returns on a case-by-case basis as customer accommodations in the past. As a result, we provide for these returns in our reserve for sales returns and allowances. At the end of each reporting period, we estimate the reserve for returns based on historical experience and knowledge of any applicable events or transactions.

Certain of our distributors have stock rotation provisions in their distributor agreements, which allow them to return 5-10% of the products purchased in the prior six months in exchange for products of equal value. We analyze historical stock rotations at the end of each reporting period. To date, returns under the stock rotation provisions have been nominal.

Certain distributors also have price protection provisions in their distributor agreements with us. Under the price protection provisions, we grant distributors credit if they purchased product for a specific customer and we subsequently lower the price to the customer such that the distributor can no longer earn its negotiated margin on in-stock inventory. At the end of each reporting period, we estimate a reserve for price protection credits based on historical experience and knowledge of any applicable events or transactions. The reserve for price protection is included in our reserve for sales returns and allowances.

*Product Warranties.* We warrant that our products will be free from defects in materials and workmanship for a period of twelve months from delivery. Warranty repairs are guaranteed for the remainder of the original warranty period. Our warranty is limited to repairing or replacing products, or refunding the purchase price.

At the end of each reporting period, we estimate a reserve for warranty returns based on historical experience and knowledge of any applicable events or transactions. While we engage in extensive product quality programs and processes, which include actively monitoring and evaluating the quality of our suppliers, should actual product failure rates or product replacement costs differ from our estimates, revisions to the estimated warranty liability may be required.

*Allowance for Doubtful Accounts.* We offer credit to customers after careful examination of their creditworthiness. We maintain an allowance for doubtful accounts for estimated losses that may result from the inability of our customers to make required payments. At the end of each reporting period, we estimate the allowance for doubtful

accounts based on our historical write-off experience and the age of outstanding receivable balances. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Inventory Valuation.* We record a reserve against our inventory for estimated obsolete, unmarketable, and otherwise impaired products by calculating the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. We review our inventory at

the end of each reporting period for valuation issues. If actual market conditions are less favorable than those we projected at the time the reserve was recorded, additional inventory write-downs may be required.

*Useful Lives and Recoverability of Equipment and Other Long-Lived Assets.* In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we evaluate the remaining useful life and recoverability of equipment and other assets, including identifiable intangible assets with definite lives, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. If there is an indicator of impairment, we prepare an estimate of future, undiscounted cash flows expected to result from the use of each asset and its eventual disposition. If these cash flows are less than the carrying value of the asset, we adjust the carrying amount of the asset to its estimated fair value. While we have concluded that the carrying value of our long-lived assets is recoverable as of December 31, 2008, our analysis is dependent upon our estimates of future cash flows, and our actual results may vary.

*Valuation of Investments.* In accordance with FSP FAS 115-1/FAS 124-1, *The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments*, we apply judgment in determining whether our marketable securities are other-than-temporarily impaired. When performing our evaluation, we consider the duration of the decline, future prospects of the issuer and our ability and intent to hold the security to recovery.

*Stock-Based Compensation.* We account for stock-based compensation in accordance with SFAS 123R. We estimate the fair value of share-based payments using the Black-Scholes option pricing model, which requires certain estimates, including an expected forfeiture rate and expected term of options granted. We also make decisions regarding the method of calculating expected volatilities and the risk-free interest rate used in the option-pricing model. The resulting calculated fair value of share-based payments is recognized as compensation expense over the requisite service period, which is generally the vesting period. When there are changes to the assumptions used in the option-pricing model, including fluctuations in the market price of our common stock, there will be variations in the calculated fair value of the share-based payments, which results in variation in the compensation cost recognized.

*Income Taxes.* We record deferred income taxes for temporary differences between the amount of assets and liabilities for financial and tax reporting purposes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. In accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109* we conduct a comprehensive review of our uncertain tax positions regularly. In this regard, an uncertain tax position represents our expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. Until these positions are sustained by the taxing authorities, we do not recognize the tax benefits resulting from such positions and report the tax effects as a liability for uncertain tax positions in our consolidated balance sheet.

Table of Contents

**Contractual Payment Obligations**

A summary of our contractual obligations as of December 31, 2008 is as follows:

| | | Payments Due By Period | | | |
|---|---|---|---|---|---|
| Contractual Obligation | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Long-term debt [1] | $ 60,634 | $ | $ 60,634 | $ | $ |
| Interest on long-term debt | 2,653 | 1,061 | 1,592 | | |
| Operating leases [2] | 6,806 | 2,182 | 3,028 | 1,596 | |
| Payments on accrued balances related to asset purchases | 1,815 | 1,116 | 699 | | |
| Estimated Q1 2009 purchase commitments to contract manufacturers | 4,531 | 4,531 | | | |
| Other purchase obligations and commitments | 1,500 | 1,000 | 500 | | |
| Total [3] | $ 77,939 | $ 9,890 | $ 66,453 | $ 1,596 | $ |

[1] The earliest date on which the holders of our 1.75% convertible subordinated debentures due 2024 have the right to require us to purchase all or a portion of the outstanding debentures is May 15, 2011. We expect holders of the debentures to require us to purchase all of the outstanding debentures on that date.

[2] The operating lease payments above are net of sublease rental income of $483,000, $194,000 and $49,000 for the years ending December 31, 2009, 2010 and 2011 respectively.

[3] We are unable to reliably estimate the timing of future payments related to uncertain tax positions; therefore, $10.6 million of income taxes payable has been excluded from the table above.

**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, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**Recent Accounting Pronouncements and Accounting Changes**

See Note 2: Summary of Significant Accounting Policies in Part II, Item 8 of this Form 10-K for a description of accounting changes and recent accounting pronouncements, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

**Interest Rate Risk**

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

Applying a hypothetical 1% decrease in interest rates to the average balances of our interest bearing cash and investment accounts would have decreased our interest income by approximately $650,000 in 2008. As of December 31, 2008 a significant majority of our cash and investments are held as cash or in money market funds with yields approaching zero and our interest income is relatively insensitive to future decreases in interest rates.

As of December 31, 2008, we had convertible subordinated debentures of $60.6 million outstanding with a fixed interest rate of 1.75%. Interest rate changes affect the fair value of the debentures, but do not affect our earnings or cash flow.

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

**Item 8. Financial Statements and Supplementary Data.**

The following financial statements and reports are included in Item 8:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2008 and 2007
Consolidated Statements of Operations for the years ended December 31, 2008, 2007 and 2006
Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006
Consolidated Statements of Shareholders Equity (Deficit) and Comprehensive Income (Loss) for the years ended December 31, 2008, 2007 and 2006
Notes to Consolidated Financial Statements

**Table of Contents**

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Pixelworks, Inc.:

We have audited the accompanying consolidated balance sheets of Pixelworks, Inc. and subsidiaries (the Company ) as of December 31, 2008 and 2007, and the related consolidated statements of operations, shareholders equity (deficit) and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pixelworks, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 2 and 7 to the consolidated financial statements, the Company changed their method of accounting for share-based payment awards effective January 1, 2006, and their method of accounting for uncertain tax positions effective January 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Pixelworks, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 16, 2009 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Portland, Oregon
March 16, 2009

**PIXELWORKS, INC.**
**CONSOLIDATED BALANCE SHEETS**
**(In thousands, except share data)**

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 53,149 | $ 74,572 |
| Short-term marketable securities | 8,058 | 34,581 |
| Accounts receivable, net | 6,149 | 6,223 |
| Inventories, net | 4,981 | 11,265 |
| Prepaid expenses and other current assets | 3,381 | 3,791 |
| Total current assets | 75,718 | 130,432 |
| Long-term marketable securities | 2,110 | 9,804 |
| Property and equipment, net | 5,187 | 6,148 |
| Other assets, net | 4,639 | 6,902 |
| Debt issuance costs, net | 692 | 2,260 |
| Acquired intangible assets, net | 3,386 | 6,370 |
| Total assets | $ 91,732 | $ 161,916 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 4,215 | $ 3,992 |
| Accrued liabilities and current portion of long-term liabilities | 9,419 | 13,848 |
| Current portion of income taxes payable | 137 | 232 |
| Total current liabilities | 13,771 | 18,072 |
| Long-term liabilities, net of current portion | 2,035 | 1,236 |
| Income taxes payable, net of current portion | 10,581 | 10,635 |
| Long-term debt | 60,634 | 140,000 |
| Total liabilities | 87,021 | 169,943 |
| Commitments and contingencies (Note 8) | | |
| Shareholders equity (deficit): | | |
| Preferred stock, $0.001 par value; 50,000,000 shares authorized, 1 share issued and outstanding as of December 31, 2008 and 2007 | | |
| Common stock, $0.001 par value; 250,000,000 shares authorized, 13,508,127 and 15,104,926 shares issued and outstanding as of December 31, 2008 and 2007, respectively | 333,974 | 333,934 |
| Exchangeable shares; 577,033 shares issued, 0 and 4,009 shares issued and outstanding as of December 31, 2008 and 2007, respectively | | 113 |
| Accumulated other comprehensive income (loss) | 55 | (4,778) |
| Accumulated deficit | (329,318) | (337,296) |

| | | |
|---|---|---|
| Total shareholders equity (deficit) | 4,711 | (8,027) |
| Total liabilities and shareholders equity | $ 91,732 | $ 161,916 |

See accompanying notes to consolidated financial statements.

**Table of Contents**

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2008** | **2007** | **2006** |
| Revenue, net | $ 85,164 | $ 105,980 | $ 133,607 |
| Cost of revenue (1) | 42,963 | 59,273 | 107,506 |
| Gross profit | 42,201 | 46,707 | 26,101 |
| Operating expenses: | | | |
| Research and development (2) | 26,512 | 38,792 | 57,019 |
| Selling, general and administrative (3) | 17,945 | 25,437 | 35,053 |
| Restructuring | 1,589 | 13,285 | 13,316 |
| Amortization of acquired intangible assets | 164 | 359 | 602 |
| Impairment loss on goodwill | | | 133,739 |
| Impairment loss on acquired intangible assets | | | 1,753 |
| Total operating expenses | 46,210 | 77,873 | 241,482 |
| Loss from operations | (4,009) | (31,166) | (215,381) |
| Gain on repurchase of long-term debt, net | 19,670 | | 3,009 |
| Other-than-temporary impairment of marketable security | (7,890) | | |
| Interest income | 2,102 | 5,786 | 5,833 |
| Interest expense | (1,695) | (2,642) | (2,721) |
| Amortization of debt issuance costs | (426) | (661) | (667) |
| Settlement proceeds, net | | | 4,800 |
| Other income | 218 | | |
| Interest and other income, net | 11,979 | 2,483 | 10,254 |
| Income (loss) before income taxes | 7,970 | (28,683) | (205,127) |
| Provision (benefit) for income taxes | (8) | 2,237 | (949) |
| Net income (loss) | $ 7,978 | $ (30,920) | $ (204,178) |
| Net income (loss) per share | | | |
| Basic | $ 0.55 | $ (1.92) | $ (12.69) |
| Diluted | $ 0.55 | $ (1.92) | $ (12.69) |
| Weighted average shares outstanding | | | |
| Basic | 14,399 | 16,069 | 16,096 |
| Diluted | 14,410 | 16,069 | 16,096 |

| | | | |
|---|---|---|---|
| (1) Includes: | | | |
| Amortization of acquired developed technology | $ 2,820 | $ 2,820 | $ 4,087 |
| Additional amortization of non-cancelable prepaid royalty | 144 | | |
| Restructuring | 91 | 172 | 2,119 |
| Stock-based compensation | 58 | 98 | 208 |
| Impairment loss on acquired developed technology | | | 21,330 |
| Amortization of acquired inventory mark-up | | | 26 |
| (2) Includes stock-based compensation | 1,250 | 2,320 | 3,884 |
| (3) Includes stock-based compensation | 1,198 | 3,527 | 5,464 |

See accompanying notes to consolidated financial statements.

Table of Contents

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Cash flows from operating activities: | | | |
| Net income (loss) | $ 7,978 | $ (30,920) | $ (204,178) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Gain on repurchase of long-term debt, net | (19,670) | | (3,009) |
| Other-than-temporary impairment of marketable security | 7,890 | | |
| Depreciation and amortization | 6,700 | 13,999 | 17,667 |
| Amortization of acquired intangible assets | 2,984 | 3,179 | 4,689 |
| Stock-based compensation | 2,506 | 5,945 | 9,556 |
| Amortization of debt issuance costs | 426 | 661 | 667 |
| Accretion on short- and long-term marketable securities | (345) | (583) | (246) |
| Deferred income tax expense (benefit) | 291 | 512 | (967) |
| Loss on asset disposals | 180 | 210 | 90 |
| Write off of assets to restructuring | 14 | 3,905 | 11,618 |
| Impairment losses on goodwill and acquired intangible assets | | | 156,822 |
| Other | 55 | 55 | 100 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable, net | 74 | 3,092 | 10,612 |
| Inventories, net | 6,284 | 2,544 | 12,768 |
| Prepaid expenses and other current and long-term assets, net | 974 | 3,300 | 842 |
| Accounts payable | 223 | (4,101) | (2,742) |
| Accrued current and long-term liabilities | (1,454) | (2,995) | 1,041 |
| Income taxes payable | (149) | (130) | 1,490 |
| Net cash provided by (used in) operating activities | 14,961 | (1,327) | 16,820 |
| Cash flows from investing activities: | | | |
| Proceeds from sales and maturities of available-for-sale marketable securities | 54,532 | 79,482 | 47,647 |
| Purchases of marketable securities | (22,999) | (52,885) | (42,044) |
| Purchases of property and equipment | (2,158) | (2,886) | (5,255) |
| Proceeds from sales of property and equipment | 20 | 26 | 36 |
| Purchases of other assets | | (303) | (278) |
| Net cash provided by investing activities | 29,395 | 23,434 | 106 |
| Cash flows from financing activities: | | | |
| Repurchase of long-term debt | (58,554) | | (6,800) |
| Payments on asset financings | (4,646) | (6,715) | (17,178) |
| Repurchase of common stock | (2,626) | (4,269) | |
| Proceeds from issuances of common stock | 47 | 354 | 1,543 |

| | | | |
|---|---|---|---|
| Net cash used in financing activities | (65,779) | (10,630) | (22,435) |
| Net change in cash and cash equivalents | (21,423) | 11,477 | (5,509) |
| Cash and cash equivalents, beginning of period | 74,572 | 63,095 | 68,604 |
| Cash and cash equivalents, end of period | $ 53,149 | $ 74,572 | $ 63,095 |

See accompanying notes to consolidated financial statements.

**PIXELWORKS, INC.**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (DEFICIT) AND COMPREHENSIVE INCOME (LOSS)**
**(In thousands, except share data)**

| | Common Stock | | Exchangeable Shares | | Accumulated Other Comprehensive Income (loss) | Comprehensive Income (loss) | Deferred Stock-based Compensation | Accumulated Deficit | To Sharel Eq (De |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | |
| **e as of ber 31, 2005** | 15,722,676 | $ 316,257 | 191,489 | $ 5,434 | $ (3,503) | | $ (773) | $ (102,198) | $ 2 |
| sued under stock nd stock e plans | 306,227 | 1,543 | | | | | | | |
| sion of geable shares nmon stock | 175,611 | 4,984 | (175,611) | (4,984) | | | | | |
| djustment to FAS 123R | | (773) | | | | | 773 | | |
| ased sation expense | | 9,556 | | | | | | | |
| | | | | | | $ (204,178) | | (204,178) | (20 |
| zed loss on e-for-sale es, net of tax of | | | | | (142) | (142) | | | |
| djustment to FAS 158, net of 16 | | | | | (48) | (48) | | | |
| hensive loss | | | | | | $ (204,368) | | | |
| **e as of ber 31, 2006** | 16,204,514 | 331,567 | 15,878 | 450 | (3,693) | | | (306,376) | 2 |
| sued under stock nd stock e plans | 149,376 | 354 | | | | | | | |
| ase of common | (1,260,833) | (4,269) | | | | | | | |
| sion of geable shares nmon stock | 11,869 | 337 | (11,869) | (337) | | | | | |
| ased sation expense | | 5,945 | | | | | | | |
| | | | | | | $ (30,920) | | (30,920) | (3 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| zed loss on e-for-sale es, net of tax of | | | | | (1,090) | (1,090) | | | |
| adjustment, net f $2 | | | | | 5 | 5 | | | |
| hensive loss | | | | | | $ (32,005) | | | |
| **e as of ber 31, 2007** | 15,104,926 | 333,934 | 4,009 | 113 | (4,778) | | | (337,296) | |
| sued under stock nd stock e plans | 24,929 | 47 | | | | | | | |
| hase of common | (1,625,737) | (2,626) | | | | | | | |
| sion of geable shares nmon stock | 4,009 | 113 | (4,009) | (113) | | | | | |
| ased sation expense | | 2,506 | | | | | | | |
| ome | | | | | | $ 7,978 | | 7,978 | |
| fication ent from lated other hensive income an-temporary marketable included in net net of tax of $0 | | | | | 4,810 | 4,810 | | | |
| zed loss on e-for-sale es, net of tax of | | | | | 50 | 50 | | | |
| adjustment, net f $(7) | | | | | (27) | (27) | | | |
| hensive Income | | | | | | $ 12,811 | | | |
| **e as of ber 31, 2008** | 13,508,127 | $ 333,974 | | $ | $ 55 | | $ | $ (329,318) | $ |

See accompanying notes to consolidated financial statements.

52

Table of Contents

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

## NOTE 1. BASIS OF PRESENTATION

### Nature of Business

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

### Consolidated Financial Statements

Our consolidated financial statements include the accounts of Pixelworks and its wholly-owned subsidiaries. Intercompany accounts and transactions have been eliminated. All foreign subsidiaries use the U.S. dollar as the functional currency, and as a result, transaction gains and losses are included in the statement of operations. Transaction gains (losses) were $(121), $578 and $(151) for the years ended December 31, 2008, 2007 and 2006, respectively.

### Use of Estimates

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

### Reclassifications

Certain reclassifications have been made to the 2007 and 2006 condensed consolidated financial statements to conform with the 2008 presentation, including the reclassification of payments on asset financing as financing activities in the consolidated statements of cash flow. Similar amounts will be reclassified in future filings for prior periods.

## NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Cash and Cash Equivalents

We classify all highly liquid investments with original maturities of three months or less at the date of purchase as cash and cash equivalents. Cash equivalents totaled $34,213 and $69,158 at December 31, 2008 and 2007, respectively.

**Marketable Securities**

Our investments in marketable securities are classified as available-for-sale in accordance with Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards No. ( SFAS ) 115, *Accounting for Certain Investments in Debt and Equity Securities* ( SFAS 115 ). Available-for-sale securities

are stated at fair value based on quoted market prices with unrealized holding gains or losses, net of tax, included in accumulated other comprehensive income, a component of shareholders equity. The cost of securities sold is based on the specific identification method.

We periodically evaluate whether declines in fair values of our investments below their cost are other-than-temporary. This evaluation includes qualitative and quantitative factors regarding the severity and duration of the unrealized loss, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and our ability and intent to hold the investment for a period of time to allow for an anticipated recovery in market value.

Short and long-term marketable debt securities have remaining maturities of twelve months or less and greater than twelve months, respectively.

**Accounts Receivable**

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

We maintain an allowance for doubtful accounts for estimated losses that may result from the inability of our customers to make required payments. The balance is determined based on our historical write-off experience and the age of outstanding receivables at each reporting date. The determination to write-off specific accounts receivable balances is made based on likelihood of collection and past due status. Past due status is based on invoice date and terms specific to each customer.

**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), net of a reserve for slow-moving and obsolete items.

**Property and Equipment**

Property and equipment are stated at cost. Depreciation is calculated on a straight-line basis over the estimated useful life of the assets as follows:

| | |
|---|---|
| Software | Lesser of 3 years or contractual license term |
| Equipment, furniture and fixtures | 2 years |
| Tooling | 2 years |
| Leasehold improvements | Lessor of lease term or estimated useful life |

Reviews for impairment of property and equipment are performed whenever events or circumstances indicate that the carrying amount of assets may not be recoverable, or that the useful life of assets is shorter than originally estimated. Impairment is assessed in accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-lived Assets* ( SFAS 144 ), by comparing the projected undiscounted net cash flows associated with the assets over their remaining useful lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of the assets.

The cost of property and equipment repairs and maintenance is expensed as incurred.

**Acquired Intangible Assets**

Intangible assets are amortized on a straight-line basis over their estimated useful lives; developed technology, five to seven years and customer relationships three years. Acquired intangible assets are reviewed whenever events or circumstances indicate that the carrying amount of the assets may not be recoverable, or that the useful life of an asset is shorter than originally estimated. If such events or circumstances exist, the assets are assessed for recoverability in accordance with SFAS 144.

Table of Contents

**Licensed Technology**

We have capitalized licensed technology assets in other long-term assets. These assets are stated at cost and are amortized on a straight-line basis over the term of the license or the estimated life of the asset, if the license is not contractually limited, which is generally three to five years. These assets are assessed for impairment in accordance with SFAS 144 whenever events or circumstances indicate that their carrying amount may not be recoverable, or that their useful lives may be shorter than originally estimated.

**Goodwill**

Goodwill represented the excess cost over the fair value of net assets acquired in business combinations. Goodwill was tested annually for impairment and more frequently if events and circumstances indicated that it might be impaired. The impairment tests were performed in accordance with SFAS 142, *Goodwill and Other Intangible Assets.*

**Revenue Recognition**

We recognize revenue in accordance with Staff Accounting Bulletin No. ( SAB ) 104, *Revenue Recognition*. Accordingly, we recognize revenue from product sales to customers and distributors upon shipment provided that:

- an authorized purchase order has been received;
- title and risk of loss have transferred;
- the sales price is fixed or determinable; and
- collectibility of the receivable is reasonably assured.

There are no customer acceptance provisions associated with our products, and except for replacement of defective products under our warranty program discussed below, we have no obligation to accept product returns from end customers. However, we have accepted returns on a case-by-case basis as customer accommodations in the past. As a result, we provide for estimated reductions to gross profit for these sales returns in our reserve for sales returns and allowances. At the end of each reporting period, we estimate the reserve based on historical experience and knowledge of any applicable events or transactions. The reserve is included in accrued liabilities in our consolidated balance sheet.

A portion of our sales are made to distributors under agreements that grant the distributor limited stock rotation rights and price protection on in-stock inventory. The stock rotation rights allow these distributors to exchange a limited amount of their in-stock inventory for other Pixelworks product. We analyze historical stock rotations at the end of each reporting period. To date, returns under the stock rotation provisions have been nominal, and as a result, we have not recorded a reserve for stock rotations. Under the price protection provisions, we grant distributors credit if they purchased product for a specific customer and we subsequently lower the price to the customer such that the distributor can no longer earn its negotiated margin on in-stock inventory. At the end of each reporting period, we estimate a reserve for price protection credits based on historical experience and knowledge of any applicable events or transactions. The reserve for price protection is included in our reserve for sales returns and allowances, which is included in accrued liabilities in our consolidated balance sheet.

**Warranty Program**

We warrant that our products will be free from defects in material and workmanship for a period of twelve months from delivery. Warranty repairs are guaranteed for the remainder of the original warranty period. Our warranty is limited to repairing or replacing products, or refunding the purchase price. At the end of each reporting period, we estimate a reserve for warranty returns based on historical experience and knowledge of any applicable events or

transactions. While we engage in extensive product quality programs and processes, which include actively monitoring and evaluating the quality of our suppliers, should actual product failure rates or product replacement costs differ from our estimates, revisions to the estimated warranty liability may



---

be required. The reserve for warranty returns is included in accrued liabilities in our consolidated balance sheet.

**Stock-Based Compensation**

On January 1, 2006, we adopted SFAS 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ), which requires the measurement and recognition of compensation expense for all share-based payment awards, including stock options, based on the estimated fair value of the awards. Under SFAS 123R, the fair value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period. In March 2005, the SEC issued SAB 107 relating to SFAS 123R, which we have applied in our adoption of SFAS 123R. Upon adoption of SFAS 123R, we elected to attribute the value of stock-based compensation to expense on the straight-line basis over the requisite service period for the entire award. We used the modified prospective transition method in adopting SFAS 123R.

**Research and Development**

Costs associated with research and development activities are expensed as incurred.

**Income Taxes**

We account for income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between financial statement carrying amounts and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We establish a valuation allowance in accordance with SFAS 109, *Accounting for Income Taxes* ( SFAS 109 ), to reduce deferred tax assets to the amount expected more likely than not to be realized in future tax returns.

In accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109* ( FIN 48 ) we conduct a comprehensive review of our uncertain tax positions regularly. In this regard, an uncertain tax position represents our expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. Until these positions are sustained by the taxing authorities, we do not recognize the tax benefits resulting from such positions and report the tax effects as a liability for uncertain tax positions in our consolidated balance sheet.

**Accumulated Other Comprehensive Income (Loss)**

SFAS 130, *Reporting Comprehensive Income*, establishes standards for the reporting of comprehensive income (loss) and its components. Accumulated other comprehensive income (loss), net of tax, consists of the following:

| | December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Accumulated net unrealized holding gain (loss) on available-for-sale marketable securities | $ 125 | $ (4,735) |
| Accumulated transition pension obligation under SFAS 158 | (48) | (48) |
| Actuarial gain (loss) on pension obligation | (22) | 5 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive income (loss) | $ | 55 | $ | (4,778) |

**Leases**

We lease various office space and equipment. We classify our leases as either operating or capital lease arrangements in accordance with the criteria of SFAS 13, *Accounting for Leases*. Certain of our operating

leases for office space contain provisions under which monthly rent escalates over time and certain leases also contain provisions for reimbursement of a specified amount of leasehold improvements. When lease agreements contain escalating rent clauses, we recognize rent expense on a straight-line basis over the term of the lease. When lease agreements provide allowances for leasehold improvements, we capitalize the leasehold improvement assets and amortize them on a straight-line basis over the lesser of the lease term or the estimated useful life of the asset, and reduce rent expense on a straight-line basis over the term of the lease by the amount of the asset capitalized.

**Fair Value of Financial Instruments**

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. Our cash equivalents and short- and long-term marketable securities are recorded at fair value in the consolidated balance sheet in accordance with SFAS 115. The fair value of our long-term debt was $36,890 as of December 31, 2008, as compared to its carrying value of $60,634. The fair value of long-term debt at December 31, 2008 is based on the quoted market price of the debt.

**Risks and Uncertainties**

*Concentration of Suppliers*

We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. We rely on three third-party foundries to produce all of our wafers and three assembly and test vendors for completion of finished products. We do not have any long-term agreements with any of these suppliers. In light of these dependencies, it is reasonably possible that failure to perform by one of these suppliers could have a severe impact on our results of operations.

*Risk of Technological Change*

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

*Concentrations of Credit Risk*

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

**Recent Accounting Pronouncements**

In December 2007, the FASB issued SFAS 141 (revised 2007), *Business Combinations* ( SFAS 141R ), which replaces SFAS 141, *Business Combinations*. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, including goodwill, the liabilities assumed and any non-controlling interest in the acquiree. SFAS 141R also establishes disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of a business combination and is effective for our business combinations, if any, occurring after January 1, 2009. SFAS 141R also requires that any future benefit, if recognized due to the reversal of our valuation allowance on $3,342 of our acquired deferred tax

assets, will be recognized as an adjustment to income tax expense, rather than allocated to acquired intangible assets.

Table of Contents

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements.* The FASB amended SFAS 157 by issuing FSP FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13,* and FSP FAS 157-2, *Effective Date of FASB Statement No. 157* and in October 2008*, FSP FAS 157-3 Determining the Fair value of a Financial Asset When the Market for That Asset Is Not Active* (collectively SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements to require a three-level hierarchical classification of the inputs used in measuring fair value. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements, except those relating to lease classification, and accordingly does not require any new fair value measurements. SFAS 157 is effective for financial assets and financial liabilities in fiscal years beginning after November 15, 2007, and for nonfinancial assets and liabilities in fiscal years beginning after November 15, 2008. We adopted SFAS 157 for financial assets and liabilities on January 1, 2008 with no impact to the consolidated financial statements but with additional footnote disclosures. We do not anticipate the application of SFAS 157 to nonfinancial assets and nonfinancial liabilities will have a material impact on our consolidated financial statements.

## NOTE 3. BALANCE SHEET COMPONENTS

### Short- and Long-Term Marketable Securities

At December 31, 2008 and 2007, all of our marketable securities are classified as available-for-sale in accordance with SFAS 115 and consist of the following:

| | Cost | Unrealized Gain (Loss) | Fair Value |
|---|---|---|---|
| **Short-term marketable securities:** | | | |
| As of December 31, 2008: | | | |
| US government agencies debt securities | $ 3,487 | $ 105 | $ 3,592 |
| Commercial paper | 3,486 | 2 | 3,488 |
| Corporate debt securities | 960 | 18 | 978 |
| | $ 7,933 | $ 125 | $ 8,058 |
| As of December 31, 2007: | | | |
| Commercial paper | $ 19,573 | $ (12) | $ 19,561 |
| Foreign government debt securities | 7,005 | (5) | 7,000 |
| Corporate debt securities | 5,581 | (5) | 5,576 |
| US government agencies debt securities | 2,444 | | 2,444 |
| | $ 34,603 | $ (22) | $ 34,581 |

| | Cost | Unrealized Gain (Loss) | Fair Value |
|---|---|---|---|
| **Long-term marketable securities:** | | | |
| As of December 31, 2008: | | | |

| | | | |
|---|---|---|---|
| Equity security | $ 2,110 | $ | $ 2,110 |
| | $ 2,110 | $ | $ 2,110 |
| As of December 31, 2007: | | | |
| Equity security | $ 10,000 | $ (4,810) | $ 5,190 |
| US government agencies debt securities | 3,541 | 81 | 3,622 |
| Corporate debt securities | 976 | 16 | 992 |
| | $ 14,517 | $ (4,713) | $ 9,804 |

Table of Contents

On March 31, 2008 we analyzed our long-term equity security for other-than-temporary impairment in accordance with FASB Staff Position 115-1/124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. After reviewing the investment s rapid decline in value from December 31, 2007 to March 31, 2008, the extended duration of time which the fair value of the investment had been below our cost, as well as decreased target price estimates, analyst downgrades and macroeconomic factors, we determined that we would not recover the cost basis of the investment. Accordingly, we recognized an other-than-temporary impairment loss of $6,490 in the first quarter of 2008, which decreased our cost basis from $10,000 to $3,510. As of December 31, 2008 the value of this investment had decreased to $2,110. Based on the same factors considered in our March 31, 2008 analysis, we determined that we will not recover the $3,510 cost basis of the investment and recorded a second other-than-temporary impairment loss of $1,400 in the fourth quarter of 2008. The cumulative loss of $7,890 is included in our statement of operations for the year ended December 31, 2008. At December 31, 2007, $4,810 unrealized loss was included in accumulated other comprehensive loss related to this investment.

**Accounts Receivable, Net**

Accounts receivable, net consists of the following:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Accounts receivable, gross | $ 6,691 | $ 6,765 |
| Allowance for doubtful accounts | (542) | (542) |
| Accounts receivable, net | $ 6,149 | $ 6,223 |

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Balance at beginning of year | $ 542 | $ 200 | $ 212 |
| Provision | | 483 | |
| Recoveries | | (141) | (12) |
| Balance at end of year | $ 542 | $ 542 | $ 200 |

**Inventories, Net**

Inventories, net consists of the following:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Finished goods | $ 4,617 | $ 12,733 |

| | | |
|---|---|---|
| Work-in-process | 5,358 | 4,482 |
| | 9,975 | 17,215 |
| Reserve for slow moving and obsolete items | (4,994) | (5,950) |
| Inventories, net | $ 4,981 | $ 11,265 |

Table of Contents

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Balance at beginning of year | $ 5,950 | $ 5,950 | $ 1,396 |
| Provision | 1,496 | 4,365 | 6,215 |
| Usage: | | | |
| Scrap | (1,444) | (2,376) | (1,282) |
| Sales | (1,008) | (1,989) | (379) |
| Total usage | (2,452) | (4,365) | (1,661) |
| Balance at end of year | $ 4,994 | $ 5,950 | $ 5,950 |

Based upon our forecast and backlog we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand at December 31, 2008. However, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. During the year ended December 31, 2008, we sold $1,008 of previously reserved inventory due to unanticipated demand for products nearing end-of-life. It is not possible for us to predict if or when this may happen again, or how much we may sell. If such sales occur, we do not expect that they will have a material impact on our gross profit margin.

**Prepaid Expenses and Other Current Assets**

Prepaid expenses and other current assets consist of current prepaid expenses, deposits, income taxes receivable, other receivables and deferred tax assets.

**Property and Equipment, Net**

Property and equipment, net consists of the following:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Software | $ 9,141 | $ 6,909 |
| Equipment, furniture and fixtures | 6,668 | 6,401 |
| Tooling | 1,244 | 1,035 |
| Leasehold improvements | 3,174 | 2,764 |
| | 20,227 | 17,109 |
| Accumulated depreciation and amortization | (15,040) | (10,961) |
| Property and equipment, net | $ 5,187 | $ 6,148 |

Software amortization was $2,634, $8,374 and $7,620 for the years ended December 31, 2008, 2007 and 2006, respectively. Depreciation and amortization expense for equipment, furniture, fixtures, tooling and leasehold improvements was $2,392, $3,762 and $5,396 for the years ended December 31, 2008, 2007 and 2006, respectively.

During the year ended December 31, 2008, we recognized a loss of $103 on the disposal of unused property and equipment with an original cost of $1,087. During the years ended December 31, 2007 and 2006 we also wrote off property and equipment assets as a result of our restructuring plans. See Note 6.

**Other Assets, Net**

Other assets, net consists primarily of licensed technology as of December 31, 2008 and 2007. Amortization of licensed technology was $1,674, $1,863 and $4,651 for the years ended December 31, 2008, 2007 and 2006, respectively.

Table of Contents

During the fourth quarter of 2006, we wrote off licensed technology assets with a net book value of $9,223. The loss on these disposals is included in restructuring in our consolidated statement of operations for the year ended December 31, 2006. These assets were written off based on our decision to no longer pursue development of projects that incorporate the technology and there were no alternate future uses for the technology. See Note 6.

**Acquired Intangible Assets, Net**

Acquired intangible assets, net consists of the following:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Gross carrying amount: | | |
| Developed technology | $ 19,170 | $ 19,170 |
| Customer relationships | 1,689 | 1,689 |
| | 20,859 | 20,859 |
| Accumulated amortization: | | |
| Developed technology | (15,784) | (12,964) |
| Customer relationships | (1,689) | (1,525) |
| | (17,473) | (14,489) |
| Acquired intangible assets, net | $ 3,386 | $ 6,370 |

In April 2006, we initiated a restructuring plan to reduce our breakeven point by decreasing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol Television ( IPTV ) technology that we acquired as a result of our acquisition of Equator Technologies, Inc. ( Equator ) in June 2005 with our advanced television technology product development. We are no longer pursuing stand-alone advanced media processor markets that are not core to advanced television. As a result of this change, we performed an impairment analysis in accordance with SFAS 144 as of March 31, 2006 on acquired intangible assets. We recorded impairment losses on the developed technology, customer relationships and trademark intangible assets acquired from Equator. The impairment losses were equal to the excess of the carrying value over the estimated fair value of these intangible assets. Estimated fair value was determined using the discounted cash flow method. The new cost basis of these acquired intangible assets is being amortized over their remaining useful lives. The impairment loss of $23,083 is included in our statement of operations for the year ended December 31, 2006, of which $21,330 is related to developed technology and is included in cost of revenue.

Amortization expense was $2,984, $3,179 and $4,689 for the years ended December 31, 2008, 2007, and 2006, respectively. Estimated future amortization expense is as follows:

| | |
|---|---|
| Year ending December 31: | |
| 2009 | $ 2,336 |
| 2010 | 1,050 |
| | $ 3,386 |

**Goodwill**

We recorded goodwill in connection with our acquisitions of Equator in June 2005, nDSP Corporation ( nDSP ) in January 2002 and Panstera, Inc. ( Panstera ) in January 2001. As the market value of our common stock fell below our book value during the second quarter of 2006, we performed a goodwill impairment test on June 30, 2006. As a result of this analysis, we recorded an impairment loss on goodwill of $133,739 in the second quarter of 2006. We calculated the impairment loss based on an allocation of the fair value of the Company s equity to the fair value of the Company s assets and liabilities in a manner similar to

Table of Contents

a purchase price allocation in a business combination. In the allocation, goodwill was determined to have no implied fair value and as a result, the entire balance was written off.

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

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

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Accrued payroll and related liabilities | $ 3,749 | $ 3,366 |
| Current portion of accrued liabilities for asset financings | 1,116 | 4,150 |
| Accrued costs related to restructuring | 940 | 2,918 |
| Accrued commissions and royalties | 728 | 381 |
| Reserve for warranty returns | 593 | 932 |
| Accrued interest payable | 236 | 405 |
| Reserve for sales returns and allowances | 100 | 175 |
| Other | 1,957 | 1,521 |
| | $ 9,419 | $ 13,848 |

From time to time, we have acquired software and licensed technology assets under purchase agreements that provide extended payment terms. The payment periods vary, but generally extend over a period of one month to two years. We are obligated to make all payments accrued, and there are no contingencies attached to any of the agreements.

The following is a summary of the changes in our reserves for sales returns and allowances and warranty returns:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Reserve for warranty returns: | | | |
| Balance at beginning of year | $ 932 | $ 662 | $ 577 |
| Provision (benefit) | (203) | 1,418 | 990 |
| Charge offs | (136) | (1,148) | (905) |
| Balance at end of year | $ 593 | $ 932 | $ 662 |
| Reserve for sales returns and allowances: | | | |
| Balance at beginning of year | $ 175 | $ 479 | $ 237 |
| Provision | 25 | 123 | 665 |
| Charge offs | (100) | (427) | (423) |
| Balance at end of year | $ 100 | $ 175 | $ 479 |

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

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

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Accrued liabilities for asset financings | $ 699 | $ |
| Deferred rent | 617 | 619 |
| Accrued costs related to restructuring | 262 | 353 |
| Payroll and related liabilities | 182 | 181 |
| Other | 275 | 83 |
| | $ 2,035 | $ 1,236 |

**Long-Term Debt and Debt Issuance Costs**

On May 18, 2004, we issued $125,000 of convertible subordinated debentures (the debentures ) due 2024 in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended ( Securities Act ), and outside of the United States in accordance with Regulation S under the Securities Act. On June 4, 2004, we issued an additional $25,000 of debentures pursuant to the exercise of an option granted to the initial purchasers. The debentures have been registered with the SEC for resale under the Securities Act.

In February 2006, we repurchased and retired $10,000 of our outstanding debentures for $6,800 in cash. We recognized a net gain on the repurchase of $3,009, which included a $3,200 discount, offset by write-offs of debt issuance costs of $191. The gain is included in other income in our statement of operations for the year ended December 31, 2006.

In February 2008, we repurchased and retired $50,248 of the debentures in a modified dutch auction tender offer for $37,939 in cash. In August 2008, we repurchased and retired $29,118 of the debentures for $20,615 in a combination of open market and private transactions. We recognized a net gain of $19,670 on the repurchases, which included a $21,567 discount, offset by legal and professional fees of $755 and write-offs of debt issuance costs of $1,142. The gain is included in other income in our statement of operations for the year ended December 31, 2008. As of December 31, 2008, we have $60,634 of the debentures outstanding.

The debentures bear interest at a rate of 1.75% per annum and interest is payable on May 15 and November 15 of each year. Under certain circumstances, the debentures are convertible into our common stock at a conversion rate of 13.6876 shares of common stock per $1 principal amount of debentures, for a total of 829,934 shares. This is equivalent to a conversion price of approximately $73.06 per share. The outstanding debentures are convertible if (a) our stock trades above 130% of the conversion price for 20 out of 30 consecutive trading days during any calendar quarter, (b) the debentures trade at an amount less than or equal to 98% of the if-converted value of the notes for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other specified corporate transactions. We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of their debentures on May 15, 2011, May 15, 2014 and May 15, 2019 at a price equal to 100% of the principal amount plus accrued and unpaid interest.

The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt, and are effectively subordinated to all existing and future debt of our subsidiaries. At December 31, 2008, we had no senior debt outstanding and our subsidiaries had approximately $2,423 of liabilities to which the debentures were effectively subordinated.

The debentures meet the definition of conventional convertible debt in EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock*. We have evaluated each of the put, call and conversion features of the debentures and concluded that none of these

63

features constitute embedded derivatives that must be bifurcated from the host contract and accounted for as derivatives in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*.

The fees associated with the issuance of the convertible debentures included $4,500 withheld from the proceeds and $462 paid in cash. These debt issuance costs have been capitalized and are included in long-term assets in the consolidated balance sheets. The debt issuance costs are being amortized over seven years on a straight-line basis, which approximates the effective interest rate method.

**NOTE 4: FAIR VALUE MEASUREMENT**

On January 1, 2008, we adopted SFAS 157 for our financial assets and liabilities. SFAS 157 defines fair value and describes three levels of inputs that may be used to measure fair value:

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

Level 2: Valuations based on observable inputs other than quoted prices in active markets for identical assets and liabilities.

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

The table below presents information about our financial assets measured at fair value at December 31, 2008:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash equivalents | $ 34,213 | $ | $ | $ 34,213 |
| Short-term marketable securities | | 8,058 | | 8,058 |
| Long-term marketable securities | 2,110 | | | 2,110 |
| Total | $ 36,323 | $ 8,058 | $ | $ 44,381 |

Level 1 financial assets include money market funds and a long-term equity security. Level two financial assets include commercial paper, corporate debt securities and U.S. government agencies debt securities. We primarily use the market approach to determine the fair value of our financial assets. We do not have any financial liabilities required to be measured at fair value on a recurring basis.

On January 1, 2008, we adopted SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). SFAS 159 allows us to measure many financial instruments and certain other items at fair value. We have currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with GAAP.

**NOTE 5. EARNINGS PER SHARE**

We calculate earnings per share in accordance with SFAS 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and include exchangeable shares. The exchangeable shares, which were issued on September 6, 2002 by Jaldi Semiconductor Corporation ( Jaldi ), our Canadian subsidiary, to its shareholders in connection with the Jaldi asset acquisition, have characteristics

essentially equivalent to Pixelworks common stock. As of January 31, 2008 all exchangeable shares had been exchanged for shares of Pixelworks common stock. Basic and diluted weighted average shares outstanding have been calculated to reflect the June 4, 2008 one-for three reverse stock split in all periods presented.

Diluted weighted average shares outstanding includes the increased number of common shares that would be outstanding assuming the exercise of certain outstanding stock options, when such exercise would have the effect of reducing earnings per share, and the conversion of our debentures, using the if-converted method, when such conversion is dilutive. If our convertible debentures are dilutive, interest expense and amortization of debt issuance costs, net of tax, are added to net income used in calculating basic net income per share to arrive at net income used in calculating diluted net income per share.

Table of Contents

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Net income (loss) | $ 7,978 | $ (30,920) | $ (204,178) |
| Basic weighted average shares outstanding | 14,399 | 16,069 | 16,096 |
| Common share equivalents: | | | |
| Dilutive effect of stock options | 11 | | |
| Diluted weighted average shares outstanding | 14,410 | 16,069 | 16,096 |
| Net income (loss) per common share basic and diluted | $ 0.55 | $ (1.92) | $ (12.69) |

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Stock options | 1,793,187 | 1,962,893 | 2,870,988 |
| Conversion of debentures | 1,191,026 | 1,916,259 | 1,932,572 |

## NOTE 6. RESTRUCTURINGS

In December 2008, we initiated a restructuring plan to reduce our operating expenses in response to decreases in current and forecasted revenue which resulted from global economic uncertainty. The plan will reduce operations, research and development and administrative headcount in our San Jose, Taiwan and China offices, and will be substantially complete in the first quarter of 2009. We are evaluating the need for additional restructuring actions due to the current economic environment, but uncertainty regarding the outlook for 2009 and beyond impedes our ability to forecast the scope and impact of any potential actions.

In November 2006, we initiated a restructuring plan to reduce operating expenses and continued to implement this plan throughout 2007 and 2008. This plan included consolidation of our operations in order to reduce compensation and rent expense. As part of this plan we closed our offices in Toronto, Beijing and Shenzhen. Additionally, we eliminated all operations and research and development activities at our Tualatin location and transferred them to our offices in San Jose, Shanghai and Hsin Chu. The consolidation and closure of these offices and reduction in headcount resulted in charges for non-cancelable leases and termination and retention benefits for effected employees. In connection with this restructuring we also narrowed and redefined our product development strategy which resulted in the write-off of IP assets, tooling, software development tools and charges for related non-cancelable contracts. This plan was completed during the fourth quarter of 2008.

In April 2006, we initiated a restructuring plan to reduce our breakeven point by decreasing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol

Television ( IPTV ) technology that we acquired from Equator Technologies, Inc. ( Equator ) with our advanced television technology developments and no longer pursuing stand-alone advanced media processor markets. We consolidated our two California offices as part of this plan, which was completed during the fourth quarter of 2006.

Table of Contents

Total restructuring expense included in our consolidated statements of operations is comprised of the following:

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Cost of revenue restructuring: | | | |
| Termination and retention benefits | $ 91 | $ 172 | $ 47 |
| Licensed technology and tooling write offs | | | 2,072 |
| | 91 | 172 | 2,119 |
| Operating expenses restructuring: | | | |
| Termination and retention benefits | 1,081 | 5,248 | 2,734 |
| Consolidation of leased space | 508 | 1,524 | 1,036 |
| Net write off of assets and reversal of related liabilities | | 3,905 | 9,546 |
| Contract termination fee | | 1,693 | |
| Payments, non-cancelable contracts | | 827 | |
| Other | | 88 | |
| | 1,589 | 13,285 | 13,316 |
| Total restructuring expense | $ 1,680 | $ 13,457 | $ 15,435 |

The termination and retention benefits included severance and retention payments for terminated employees and retention payments for certain continuing employees. Expenses related to the consolidation of leased space included future non-cancelable rent payments due for vacated space (net of estimated sublease income) and moving expenses.

The net write-off of assets and reversal of related liabilities recorded during the year ended December 31, 2007 included the write-off of assets with a net book value of $6,905 and the reversal of an accrued liability of $3,000. The assets written-off and the liability reversed related primarily to engineering software tools which we are no longer using due to restructuring-related reductions in research and development personnel and changes in product development strategy. We also paid a contract termination fee of $1,693 during the year ended December 31, 2007 to cancel one of the engineering software licenses prior to its expiration. The assets written off during the year ended December 31, 2006 consisted primarily of licensed technology and tooling.

Non-cancelable contract payments during the year ended December 31, 2007 consist of amounts that we were obligated to pay, but for which we will not realize a benefit due to the restructuring plans.

Accrued expenses related to the restructuring plans are included in current and non-current accrued liabilities in the consolidated balance sheets. The following is a roll-forward of the accrued liabilities related to the restructuring plans for the years ended December 31, 2008 and 2007:

| | Balance as of December 31, 2007 | Expensed | Payments | Balance as of December 31, 2008 |
|---|---|---|---|---|
| Termination and retention benefits | $ 1,758 | $ 1,172 | $ (2,193) | $ 737 |
| Lease termination costs | 999 | 508 | (1,042) | 465 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Contract termination and other costs | | 514 | | | | (514) | | |
| Total | $ | 3,271 | $ | 1,680 | $ | (3,749) | $ | 1,202 |

66

Table of Contents

| | Balance as of December 31, 2006 | Expensed | Payments | Balance as of December 31, 2007 |
|---|---|---|---|---|
| Termination and retention benefits | $ 1,193 | $ 5,420 | $ (4,855) | $ 1,758 |
| Lease termination costs | 1,524 | 1,524 | (2,049) | 999 |
| Contract termination and other costs | | 2,520 | (2,006) | 514 |
| Total | $ 2,717 | $ 9,464 | $ (8,910) | $ 3,271 |

## NOTE 7. INCOME TAXES

### Current and Deferred Income Tax Expense (Benefit)

Domestic and foreign pre-tax income (loss) is as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Domestic | $ 6,141 | $ (31,614) | $ (206,239) |
| Foreign | 1,829 | 2,931 | 1,112 |
| | $ 7,970 | $ (28,683) | $ (205,127) |

Income tax expense (benefit) attributable to continuing operations is comprised of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Current: | | | |
| Federal | $ 55 | $ 55 | $ (1,535) |
| State | 142 | 6 | 4 |
| Foreign | (496) | 1,664 | 1,549 |
| Total current | (299) | 1,725 | 18 |
| Deferred: | | | |
| Federal | | | |
| State | | | |
| Foreign | 291 | 512 | (967) |
| Total deferred | 291 | 512 | (967) |
| Income tax expense (benefit) | $ (8) | $ 2,237 | $ (949) |

The significant components of deferred income tax expense (benefit) are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Change in gross deferred tax assets and liabilities | $ 8,537 | $ (6,915) | $ (49,304) |
| Change in valuation allowance for deferred tax assets | (8,246) | 7,427 | 48,337 |
| Deferred income tax expense (benefit) | $ 291 | $ 512 | $ (967) |

The significant differences between the U.S. federal statutory tax rate and our effective tax rate for financial statement purposes are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Expected income tax rate | 35% | 35% | 35% |
| Increase (decrease) resulting from: | | | |
| Change in valuation allowance | (67) | (40) | (13) |
| Impact of foreign earnings | 26 | | |
| Stock compensation | 3 | | |
| State income taxes, net of federal tax benefit | 2 | | 1 |
| Research and experimentation credit | | 1 | 1 |
| Decrease in deferred tax rates | | (1) | |
| Impairment loss on goodwill | | | (23) |
| Other | 1 | (3) | (1) |
| Actual tax expense | % | (8)% | % |

**Deferred Tax Assets, Liabilities and Valuation Allowance**

The tax effects of temporary differences and net operating loss carryforwards which give rise to significant portions of deferred tax assets and liabilities are as follows:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Deferred tax assets: | | |
| Net operating loss carryforwards | $ 73,861 | $ 79,420 |
| Research and experimentation credit carryforwards | 12,951 | 15,600 |
| Foreign tax credit carryforwards | 9,073 | 9,486 |
| Deferred compensation | 3,372 | 2,975 |
| Other-than-temporary impairment of marketable security | 2,983 | |
| Reserves and accrued expenses | 2,651 | 3,734 |
| Depreciation | 2,613 | 1,797 |
| Accrued vacation | 338 | 253 |
| Other | 2,256 | 2,282 |
| Total gross deferred tax assets | 110,098 | 115,547 |
| Deferred tax liabilities: | | |
| Amortization | (1,225) | (2,350) |
| Foreign earnings | (3,983) | |
| Other | (230) | |
| | (5,438) | (2,350) |
| Less valuation allowance | (104,090) | (112,336) |

| | | | | |
|---|---|---|---|---|
| Net deferred tax assets | $ | 570 | $ | 861 |

The current portion of the net deferred tax asset balance is $158 and $37 as of December 31, 2008 and 2007, respectively. The current portion is included in prepaid expenses and other current assets in the consolidated balance sheet. The non-current portion of the net deferred tax asset balance is $642 and $824 as of December 31, 2008 and 2007, respectively. The non-current portion is included in other assets, net in the

Table of Contents

consolidated balance sheet, and is partially offset by a contingency reserve of $406, which is included in income taxes payable. Long term deferred tax liabilities were $230 and $0 as of December 31, 2008 and 2007, respectively, and are included in long-term liabilities, net of current portion in the consolidated balance sheet. As of December 31, 2008 we have a current tax receivable of $473 consisting of refundable foreign research and development credits and payments in excess of estimated current tax expense. This amount is included in prepaid expenses and other current assets in the consolidated balance sheet.

We continue to record a full valuation allowance against our U.S. and Canadian net deferred tax assets at December 31, 2008 and 2007 as it is not more likely than not that we will realize a benefit from these assets in a future period. We have not provided a valuation allowance against any of our other foreign net deferred tax assets as we have concluded it is more likely than not that we will realize a benefit from these assets in a future period because our subsidiaries in these jurisdictions are cost-plus taxpayers. The net valuation allowance decreased $8,246 for the year ended December 31, 2008 and increased $7,427 and $48,337 for the years ended December 31, 2007 and 2006, respectively.

As of December 31, 2008, we have available federal, state and foreign net operating loss carryforwards of approximately $180,440, $89,878 and $7,912, respectively, which will expire between 2009 and 2027. As of December 31, 2008, we have available federal, state and foreign research and experimentation tax credit carryforwards of approximately $6,837, $3,913 and $2,200, respectively, which begin expiring in 2009. We have a general foreign tax credit of $1,954 which will begin expiring in 2017.

Utilization of a portion of the net operating loss and credit carryforwards is subject to an annual limitation due to the ownership change provisions of the Internal Revenue Code of 1986, as amended, and similar state provisions. An ownership change subject to these provisions occurred for nDSP in 2002 and Equator in 2005 when we acquired these entities.

We had undistributed earnings of foreign subsidiaries of approximately $2,527 as of December 31, 2008, for which deferred taxes have not been provided. These earnings are considered indefinitely invested outside of the United States. If repatriated, some of these earnings could generate foreign tax credits that may reduce the federal tax liability associated with any future foreign dividend. We have determined that undistributed earnings and profits of our Canadian subsidiary are no longer indefinitely reinvested offshore due to the consolidation of our North American offices and we have recorded a deferred tax liability as of December 31, 2008 related to repatriation of the subsidiary s earnings.

During the year ended December 31, 2007 our Chinese subsidiary achieved designation as an integrated circuit design company, allowing us to benefit from a tax holiday in 2008 and 2009 and a 50% reduction to the applicable corporate rate in 2009, 2010 and 2011. The change in enacted tax rate resulted in the reversal of previously recorded deferred tax assets of $307 during the year ended December 31, 2007. This expense was recorded in the statement of operations and the impact on net loss per share was not significant.

**Uncertain Tax Positions**

We have recorded tax reserves to address potential exposures involving positions that could be challenged by taxing authorities. On January 1, 2007, we adopted FIN 48. As a result, we conducted a comprehensive review of our uncertain tax positions. We did not record any adjustment to retained earnings as a result of this analysis. As of January 1, 2007, the amount of our uncertain tax positions was a liability of $10,490. As of December 31, 2008 and December 31, 2007, the amount of our uncertain tax positions was a liability of $10,581, and $10,635, respectively.

Table of Contents

The following is a summary of the change in our liability for uncertain tax positions and interest and penalties for the years ended December 31, 2008 and 2007:

| | 2008 | 2007 |
|---|---|---|
| Uncertain tax positions: | | |
| Balance at beginning of year | $ 8,539 | $ 8,743 |
| Accrual for positions taken in a prior year | (49) | 334 |
| Accrual for positions taken in current year | 91 | 200 |
| Settlements | | (738) |
| Reversals due to lapse of statute of limitations | (324) | |
| Balance at end of year | $ 8,257 | $ 8,539 |
| Interest and penalties: | | |
| Balance at beginning of year | $ 2,096 | $ 1,747 |
| Accrual for positions taken in a prior year | 463 | 451 |
| Settlements | | (102) |
| Reversals due to lapse of statute of limitations | (235) | |
| Balance at end of year | $ 2,324 | $ 2,096 |

We recognize interest and penalties related to uncertain tax positions in income tax expense in our consolidated statement of operations. We recognized interest and penalties of $463, $451 and $387 for the years ended December 31, 2008, 2007 and 2006, respectively.

We file income tax returns in the U.S. and various foreign jurisdictions. A number of years may elapse before an uncertain tax position is resolved by settlement or statute of limitations. Settlement of any particular position could require the use of cash. If the uncertain tax positions we have accrued for are sustained by the taxing authorities in our favor, the reduction of the liability will reduce our effective tax rate. We reasonably expect reductions in the liability for unrecognized tax benefits of approximately $2,078 within the next twelve months due to the expiration of statutes of limitations in foreign jurisdictions.

We are no longer subject to U.S. federal examinations for years before 2005. We are subject to potential tax examinations in foreign locations for years 2003 through 2008. We do not anticipate that any potential tax adjustments will have a significant impact on our financial position or results of operations.

We were not subject to, nor had we received any notice of, income tax examinations as of December 31, 2008.

## NOTE 8. COMMITMENTS AND CONTINGENCIES

### Royalties

We license technology from third parties and have agreed to pay certain suppliers a royalty based on the number of chips sold or manufactured, the net sales price of the chips containing the licensed technology or a fixed non-cancelable fee. Royalty expense is recognized based on our estimated average unit cost for royalty contracts with non-cancelable prepayments and the stated contractual per unit rate for all other agreements. Royalty expense was

$1,378, $2,073 and $2,767 for the years ended December 31, 2008, 2007 and 2006, respectively, which is included in cost of revenue in the consolidated statements of operations. We have a non-cancelable royalty obligation of $1,500 at December 31, 2008

**401(k) Plan**

We have a profit-sharing plan for eligible employees under the provisions of Internal Revenue Code Section 401(k). Participants may defer a percentage of their annual compensation on a pre-tax basis, not to exceed the dollar limit that is set by law. A discretionary matching contribution by the Company is allowed

and is equal to a uniform percentage of the amount of salary reduction elected to be deferred, which percentage will be determined each year by the Company. The Company made no contributions to the 401(k) plan during 2008, 2007 or 2006.

**Leases**

At December 31, 2008, future minimum payments under operating leases are as follows:

| Year Ending December 31: | | |
|---|---|---|
| 2009 | $ | 2,182 |
| 2010 | | 1,688 |
| 2011 | | 1,340 |
| 2012 | | 1,073 |
| 2013 | | 523 |
| | $ | 6,806 |

Minimum lease payments above are net of sublease rentals of $483, $194 and $49, for the years ended December 31, 2009 through 2011, respectively. Rent expense for the years ended December 31, 2008, 2007 and 2006 was $2,421, $2,747 and $4,437, respectively.

**Contract Manufacturers**

In the normal course of business, we commit to purchase products from our contract manufacturers to be delivered within the next 90 days. In certain situations, should we cancel an order, we could be required to pay cancellation fees. Such obligations could impact our immediate results of operations but would not materially affect our business.

**Indemnifications**

Certain of our agreements include limited indemnification provisions for claims from third-parties relating to our intellectual property. Such indemnification provisions are accounted for in accordance with FASB Summary of Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others-an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*. The indemnification is limited to the amount paid by the customer. As of December 31, 2008, we have not incurred any material liabilities arising from these indemnification obligations. However, in the future such obligations could immediately impact our results of operations but are not expected to materially affect our business.

**Legal Proceedings**

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

In the fourth quarter of 2006, our claim against funds placed in escrow in connection with the Equator acquisition was settled. We received proceeds net of legal fees of $4,800, which is included in our consolidated statement of

operations for the year ended December 31, 2006.

Table of Contents

## NOTE 9. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Supplemental disclosure of cash flow information is as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Cash paid during the year for: | | | |
| Interest | $ 1,882 | $ 2,618 | $ 2,657 |
| Income taxes, net of refunds received | 218 | 101 | 123 |
| Non-cash investing and financing activities: | | | |
| Acquisitions of property and equipment and other assets under extended payment terms | $ 1,815 | $ 1,818 | $ 5,822 |
| Increase in leasehold improvements and deferred rent related to tenant improvement allowances received | 140 | | 1,002 |

## NOTE 10. SHAREHOLDERS EQUITY

### Preferred Stock

The Company is authorized to issue 50,000,000 shares of preferred stock with a par value of $0.001 per share. The Board of Directors is authorized to fix or alter the rights, preferences, privileges and restrictions granted to, or imposed on, each series of preferred stock.

As of December 31, 2008 and 2007, there is one series of preferred stock designated as the Special Voting Share Series, of which there is one voting share issued and outstanding. The series was designated and the share was issued in 2002 in connection with our Jaldi asset acquisition. The voting share entitles the holders of exchangeable shares to vote on any matters that come before the Pixelworks common shareholders.

The holder of the voting share is not entitled to receive dividends. In the event of any dissolution of the Company, the holder of the voting share is entitled to be paid out of the net assets of the Company an amount equal to $0.001, before any payment is made to the holders of common stock.

### Common Stock

The Company is authorized to issue 250,000,000 shares of common stock with a par value of $0.001 per share. Shareholders of common stock have unlimited voting rights and are entitled to receive the net assets of the Company upon dissolution, subject to the rights of the preferred shareholders.

### Exchangeable Shares

In connection with the Jaldi asset acquisition, Jaldi issued 577,033 exchangeable shares to its shareholders. The voting shares described above were held in trust for the benefit of the holders of the exchangeable shares and provided the holders of the exchangeable shares with dividend, voting and other rights equivalent to those of Pixelworks common shareholders. These exchangeable shares were the economic equivalent of Pixelworks common shares, and were exchangeable at any time for Pixelworks common stock on a one-for-one basis. As of January 31, 2008 all exchangeable shares had been exchanged for shares of Pixelworks common stock.

**Reverse Stock Split**

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

Table of Contents

**Stock Incentive Plans**

On May 23, 2006, our shareholders approved the adoption of the Pixelworks, Inc. 2006 Stock Incentive Plan (the 2006 Plan ), under which 1,333,333 shares of our common stock could be issued. On May 20, 2008 our shareholders approved an increase to the total number of authorized shares to 2,333,333. The 2006 Plan replaced our previously existing stock incentive plans including our 1997 Stock Incentive Plan, as amended, our 2001 Nonqualified Stock Option Plan, the Equator Technologies, Inc. 1996 Stock Incentive Plan, as amended, and Equator Technologies, Inc. stand-alone option plans (collectively, Old Stock Incentive Plans ). Upon adoption of the 2006 Plan, no additional options could be issued under the Old Stock Incentive Plans, although awards previously granted under the Old Stock Incentive Plans remain outstanding according to their original terms. As of December 31, 2008, 1,175,689 shares were available for grant under the 2006 Plan.

*Stock Options*

Options granted must generally be exercised while the individual is an employee and within seven or ten years of the date of grant. Our new hire vesting schedule provides that each option becomes exercisable at a rate of 25% on the first anniversary date of the grant and 2.083% on the last day of every month thereafter for a total of 36 additional increments. During August 2006, we changed our merit vesting schedule to provide that merit-type awards become exercisable monthly over a period of three years. Prior to August 2006, our merit vesting schedule provided that options become exercisable monthly over a period of four years, with 10% becoming exercisable in the first year, 20% becoming exercisable in the second year, 30% becoming exercisable in the third year and 40% becoming exercisable in the fourth year.

The following is a summary of stock option activity:

| | Number of shares | Weighted average exercise price |
|---|---|---|
| Options outstanding as of December 31, 2007 | 1,604,372 | $ 19.07 |
| Granted | 649,387 | 2.88 |
| Exercised | (1,376) | 0.48 |
| Forfeited | (126,609) | 8.42 |
| Expired | (171,078) | 16.06 |
| Options outstanding as of December 31, 2008 | 1,954,696 | $ 14.66 |

On October 26, 2006, our shareholders approved a stock option exchange program under which eligible employees could elect to exchange eligible outstanding stock options. Eligible options were surrendered in exchange for new options at a rate of 4-to-1, at the then current market price of our common stock and have a new vesting schedule. These new options have a seven-year life with 33% vesting on June 30, 2007 and the remaining 67% on a monthly basis over the following 12 months, for a total of 18 months, subject to continued employment. As of December 31, 2008 all options granted in the exchange program that remained outstanding were fully vested. The stock option exchange was effected on December 4, 2006, whereby 184 employees surrendered 579,973 options in exchange for 144,993 options with an exercise price of $7.47 per share.

The following table summarizes information about options outstanding at December 31, 2008:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise prices | Number outstanding as of December 31, 2008 | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable as of December 31, 2008 | Weighted average exercise price |
| $ 0.21 - $ 6.00 | 813,490 | 7.93 | $ 2.60 | 227,300 | $ 3.07 |
| 6.01 - 12.00 | 337,413 | 5.59 | 7.32 | 258,223 | 7.33 |
| 12.01 - 18.00 | 137,796 | 6.38 | 14.72 | 86,501 | 14.79 |
| 18.01 - 24.00 | 229,074 | 3.44 | 21.56 | 217,397 | 21.53 |
| 24.01 - 30.00 | 217,570 | 5.30 | 27.41 | 208,338 | 27.41 |
| 30.01 - 36.00 | 5,591 | 6.04 | 31.75 | 5,329 | 31.82 |
| 36.01 - 42.00 | 1,666 | 4.92 | 40.20 | 1,666 | 40.20 |
| 42.01 - 48.00 | 82,947 | 5.16 | 46.19 | 82,947 | 46.19 |
| 48.01 - 54.00 | 89,666 | 3.22 | 49.77 | 89,666 | 49.77 |
| 54.01 - 68.00 | 39,483 | 2.07 | 66.03 | 39,483 | 66.03 |
| $ 0.21 - $68.00 | 1,954,696 | 6.14 | $ 14.66 | 1,216,850 | $ 20.87 |

During the years ended December 31, 2008 and 2007, the total intrinsic value of options exercised was $2 and $82, respectively, for which no income tax benefit has been recorded because a full valuation allowance has been provided for our deferred tax assets. As of December 31, 2008, options outstanding had a total intrinsic value of $5.

Options outstanding that have vested and are expected to vest as of December 31, 2008 are as follows:

| | Number of shares | Weighted average exercise price | Weighted average remaining contractual term | Aggregate intrinsic value |
|---|---|---|---|---|
| Vested | 1,216,850 | $ 20.87 | 5.13 | $ 3 |
| Expected to vest | 576,612 | 4.73 | 7.65 | 1 |
| Total | 1,793,462 | $ 15.68 | 5.94 | $ 4 |

*Restricted Stock Awards*

During the year ended December 31, 2007, we granted one restricted stock award for 50,000 shares with a fair value of $4.26 per share. As of December 31, 2007, the award was fully vested and there were no unvested stock awards outstanding. No restricted stock awards were granted during 2008, and there were no unvested restricted stock awards

outstanding at December 31, 2008.

**Employee Stock Purchase Plan**

A total of 740,000 shares of common stock have been reserved for issuance under the Employee Stock Purchase Plan ( ESPP ). The number of shares available for issuance under the ESPP increases each year in an amount equal to the lesser of (i) the number of shares of common stock issued pursuant to the ESPP during the immediately preceding fiscal year, (ii) two percent of the outstanding shares of common stock on the first day of the year for which the increase is being made or (iii) a lesser amount determined by the Board of Directors. During the years ended December 31, 2008, 2007 and 2006, we issued 23,553, 75,145 and

120,059 shares under the ESPP for proceeds of $45, $317 and $1,091, respectively. As of December 31, 2008, there were 239,061 shares available for issuance under the ESPP.

**Stock-Based Compensation Expense**

The fair value of stock-based compensation was determined using the Black-Scholes option pricing model and the following weighted average assumptions:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2008** | **2007** | **2006** |
| Stock Option Plans: | | | |
| Risk free interest rate | 2.71% | 4.65% | 4.00% |
| Expected dividend yield | 0% | 0% | 0% |
| Expected life (in years) | 4.8 | 5.2 | 3.6 |
| Volatility | 68% | 70% | 61% |
| Employee Stock Purchase Plan: | | | |
| Risk free interest rate | 2.05% | 5.09% | 4.91% |
| Expected dividend yield | 0% | 0% | 0% |
| Expected life (in years) | 0.5 | 0.5 | 0.5 |
| Volatility | 85% | 55% | 57% |

The weighted average fair value of options granted during the years ended December 31, 2008, 2007 and 2006 was $1.13, $3.06 and $5.67, respectively. The risk free interest rate is estimated using an average of treasury bill interest rates. The expected dividend yield is zero as we have not paid any dividends to date and do not expect to pay dividends in the future. The expected term is estimated using expected and historical exercise behavior. Expected volatility is estimated based on the historical volatility of our common stock over the expected life of the options as this represents our best estimate of future volatility.

As of December 31, 2008, unrecognized compensation cost is $1,670, which is expected to be recognized as compensation expense over a weighted average period of 2.4 years.

No stock-based compensation cost was capitalized as part of an asset during the years ended December 31, 2008 and 2007. Prior to the adoption of SFAS 123R, benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows on a prospective basis. This amount would be shown as Excess tax benefit from exercise of stock options on the consolidated statement of cash flows. There were no realized excess tax benefits in the years ended December 31, 2008, 2007 and 2006.

**Stock Repurchase**

On September 25, 2007, we announced a share repurchase program under which the Board of Directors authorized the repurchase of up to $10,000 of the Company s common stock over the next twelve months. In August 2008, the Board of Directors approved an extension to the program for an additional twelve months, through September 2009. The program does not obligate the Company to acquire any particular amount of common stock and may be modified or suspended at any time at the Company s discretion. Share repurchases under the program may be made through open market and privately negotiated transactions at the Company s discretion, subject to market conditions and other

factors. During 2008 we repurchased 1,625,737 common shares at a cost of $2,626. As of December 31, 2008, $3,105 remained available for repurchase under the plan. Additionally, between January 1, 2009 and February 28, 2009, we repurchased an additional 228,600 shares of our common stock for $167 under the plan.

Table of Contents

## NOTE 11. SEGMENT INFORMATION

In accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*, we have identified a single operating segment: the design and development of integrated circuits for use in electronic display devices. Substantially all of our assets are located in the U.S.

### Geographic Information

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Japan | $ 50,408 | $ 60,135 | $ 58,958 |
| Taiwan | 10,582 | 12,053 | 17,798 |
| Europe | 6,639 | 6,734 | 9,035 |
| Korea | 5,583 | 8,338 | 12,055 |
| U.S. | 3,872 | 4,627 | 5,571 |
| China | 1,734 | 6,253 | 18,098 |
| Canada | | | 6,821 |
| Other | 6,346 | 7,840 | 5,271 |
| | $ 85,164 | $ 105,980 | $ 133,607 |

### Significant Customers

Sales to distributors represented 53%, 57%, and 52% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. One distributor accounted for more than 10% of total revenue for each of the years ended December 31, 2008, 2007 and 2006. This distributor represented 32%, 33% and 26% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively.

End customers include customers who purchase directly from the Company, as well as customers who purchase products indirectly through distributors and manufacturers representatives. Revenue attributable to our top five end customers represented 55%, 47% and 39% of revenue for the years ended December 31, 2008, 2007 and 2006, respectively. For the years ended December 31, 2008, 2007 and 2006, one end customer represented 24%, 21% and 15% of revenue, respectively.

Each of the following accounts represented 10% or more of gross accounts receivable:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Account A | 32% | 27% |
| Account B | 20% | 0% |
| Account C | 15% | 3% |
| Account D | 0% | 21% |

## NOTE 12. QUARTERLY FINANCIAL DATA (UNAUDITED)

| | Quarterly Period Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| **2008** | | | | |
| Revenue, net | $ 23,976 | $ 20,793 | $ 21,479 | $ 18,916 |
| Gross profit | 11,671 | 10,498 | 11,451 | 8,581 |
| Income (loss) from operations | (835) | (1,102) | 441 | (2,513) |
| Income (loss) before income taxes | 4,496 | (875) | 8,533 | (4,184) |
| Net income (loss) | 6,133 | (1,250) | 8,219 | (5,124) |
| Net income (loss) per share: | | | | |
| Basic | 0.41 | (0.09) | 0.57 | (.37) |
| Diluted | 0.41 | (0.09) | 0.56 | (.37) |
| **2007** | | | | |
| Revenue, net | $ 23,981 | $ 26,896 | $ 28,133 | $ 26,970 |
| Gross profit | 9,853 | 11,602 | 12,108 | 13,144 |
| Loss from operations | (12,505) | (7,811) | (4,285) | (6,565) |
| Loss before income taxes | (11,800) | (7,221) | (3,654) | (6,008) |
| Net loss | (12,422) | (7,620) | (4,429) | (6,449) |
| Net loss per share basic and diluted | (0.75) | (0.48) | (0.27) | (0.42) |

We recorded an accrual of $429 in the fourth quarter of 2008 for royalty and related interest expense incurred between the quarters ended September 30, 2006 and September 30, 2008. The adjustment was primarily recorded to cost of goods sold and the Company believes the amount to be immaterial to both the current and prior periods.

## NOTE 13. SUBSEQUENT EVENT

In February 2009, we repurchased and retired $27,090 of our 1.75% convertible subordinated debentures for $17,778 in cash in a private transaction. As a result of this transaction, we will recognize a net gain on the repurchase of $9,024, which includes a $9,346 discount, offset by write-offs of debt issuance costs of $288 and other fees of $34. The gain will be included in other income in our statement of operations during the first quarter of 2009. The repurchase decreased the balance of our outstanding debentures from $60,634 to $33,544.

## Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

## Item 9A. Controls and Procedures.

### Disclosure Controls and Procedures

As of the end of the period covered by this report, we conducted an evaluation under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934). Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2008, our disclosure controls and procedures were effective to ensure that information required to be disclosed in our periodic reports filed or submitted under the Securities Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures will prevent or detect all errors and all fraud. Disclosure controls and procedures, no matter how well designed, operated and managed, can provide only reasonable assurance that the objectives of the disclosure controls and procedures are met. Because of the inherent limitations of disclosure controls and procedures, no evaluation of such disclosure controls and procedures can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

### Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining a system of internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. All internal control systems, no matter how well designed, have inherent limitations.

We conducted an assessment of the effectiveness of our system of internal control over financial reporting as of December 31, 2008, the last day of our fiscal year. This assessment was based on criteria established in the framework *Internal Control Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission and included an evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment. Based on our assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles. We reviewed the results of management s assessment with the Audit Committee of our Board of Directors.

The effectiveness of our internal control over financial reporting as of December 31, 2008 has been audited by KPMG LLP, our independent registered public accounting firm, as stated in their report, which is presented below.

### Changes in Internal Control Over Financial Reporting

There were no changes to our internal control over financial reporting during the fourth quarter of 2008, which were identified in connection with management s evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the 1934 Act, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



---

Table of Contents

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders
Pixelworks, Inc.:

We have audited Pixelworks, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Pixelworks, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Pixelworks, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pixelworks Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, shareholders equity (deficit) and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2008, and our report dated March 16, 2009 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Portland, Oregon
March 16, 2009

**Table of Contents**

### Item 9B. Other Information.

Not applicable.

## PART III

### Item 10. Directors, Executive Officers and Corporate Governance.

Information concerning the directors, executive officers and corporate governance of the Company is set forth in the Company s Proxy Statement for its 2009 Annual Meeting of Shareholders (the 2009 Proxy Statement ) to be filed pursuant to Regulation 14A and is incorporated herein by reference.

### Item 11. Executive Compensation.

Information concerning executive compensation is included in our 2009 Proxy Statement and is incorporated herein by reference.

### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Information concerning security ownership of certain beneficial owners and management and related stockholder matters is included in our 2009 Proxy Statement and is incorporated herein by reference.

### Item 13. Certain Relationships and Related Transactions, and Director Independence.

Information concerning certain relationships and related transactions and director independence is included in our 2009 Proxy Statement and is incorporated herein by reference.

### Item 14. Principal Accounting Fees and Services.

Information concerning principal accounting fees and services is set forth in our 2009 Proxy Statement and is incorporated herein by reference.

## PART IV

### Item 15. Exhibits, Financial Statement Schedules.

**(a) 1. Financial Statements.**

The following financial statements are included in Item 8. Financial Statements and Supplementary Data:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2008 and 2007
Consolidated Statements of Operations for the years ended December 31, 2008, 2007 and 2006
Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006
Consolidated Statements of Shareholders Equity (Deficit) and Comprehensive Income (Loss) for the years ended December 31, 2008, 2007 and 2006
Notes to Consolidated Financial Statements

**(a) 2. Financial Statement Schedules.**

All schedules have been omitted because the required information is included in the consolidated financial statements or the notes thereto, or is not applicable or required.

**(a) 3. Exhibits.**

The exhibits are either filed with this report or incorporated by reference into this report.

| Exhibit Number | Description |
|---|---|
| 3.1 | Sixth Amended and Restated Articles of Incorporation of Pixelworks, Inc., As Amended (incorporated by reference to Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q filed on August 9, 2004). |
| 3.2 | Third Amendment to Sixth Amended and Restated Articles of Incorporation of Pixelworks, Inc. (incorporated by reference to Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q filed on August 11, 2008). |
| 3.3 | First Restated Bylaws of Pixelworks, Inc. (incorporated by reference to Exhibit 3.3 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000). |
| 4.1 | Reference is made to Exhibit 3.1 above (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000). |
| 4.2 | Third Amended Registration Rights Agreement dated February 22, 2000 (incorporated by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000). |
| 4.3 | Indenture dated May 18, 2004 between Pixelworks, Inc. and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.1 to the Company s Quarterly Report on Form 10-Q filed on August 9, 2004). |
| 4.4 | Form of 1.75% Convertible Subordinated Debentures due 2024 dated May 18, 2004 (incorporated by reference to Exhibit 4.2 to the Company s Quarterly Report on Form 10-Q filed on August 9, 2004). |
| 4.5 | Registration Rights Agreement, dated May 18, 2004 among Pixelworks, Inc., Citigroup Global Markets Inc. and D.A. Davidson & Co. (incorporated by reference to Exhibit 4.3 to the Company s Quarterly Report on Form 10-Q filed on August 9, 2004). |
| 4.6 | Purchase Agreement, dated May 12, 2004 among Pixelworks, Inc. and Citigroup Global Markets Inc. (incorporated by reference to Exhibit 4.4 to the Company s Quarterly Report on Form 10-Q filed on August 9, 2004). |
| 10.1 | Form of Indemnity Agreement between Pixelworks, Inc. and each of its Officers and Directors (incorporated by reference to Exhibit 10.1 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000).+ |
| 10.2 | Pixelworks, Inc. 1997 Stock Incentive Plan, as amended (incorporated by reference to Exhibit 99.1 to the Company s Registration Statement on Form S-8 filed on June 21, 2005).+ |
| 10.3 | Pixelworks, Inc. 2000 Employee Stock Purchase Plan, As Amended (incorporated by reference to Exhibit 99.2 to the Company s Registration Statement on Form S-8 filed on March 23, 2005).+ |
| 10.4 | Pixelworks, Inc. 2001 Nonqualified Stock Option Plan (incorporated by reference to Exhibit 99.1 to the Company s Registration Statement on Form S-8 filed on May 31, 2001).+ |
| 10.5 | Equator Technologies, Inc. 1996 Stock Option Plan, as amended (incorporated by reference to Exhibit 99.1 to the Company s Registration Statement on Form S-8 filed on June 17, 2005).+ |
| 10.6 | Pixelworks, Inc. Amended and Restated 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.2 the Company s Quarterly Report on Form 10-Q filed on August 11, 2008).+ |
| 10.7 | Summary of Pixelworks Non-Employee Director Compensation (incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed on November 7, 2008).+ |
| 10.8 | Chair and Board Service Agreement dated and effective December 12, 2006, by and between Allen Alley and Pixelworks, Inc. (incorporated by reference to Exhibit 10.9 to the Company s Annual Report on Form 10-K filed on March 12, 2007).+ |
| 10.9 | |

|  |  |
|---|---|
|  | CEO Transition Agreement dated and effective December 12, 2006, by and between Allen Alley and Pixelworks, Inc. (incorporated by reference to Exhibit 10.10 to the Company s Annual Report on Form 10-K filed on March 12, 2007).+ |
| 10.10 | Executive Employment Agreement dated and effective March 31, 2008, by and between Bruce Walicek and Pixelworks, Inc (incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed on May 8, 2008).+ |

| Exhibit Number | Description |
|---|---|
| 10.11 | Pixelworks, Inc. 2007 Senior Management Bonus Plan (incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed on May 10, 2007).+ |
| 10.12 | Pixelworks, Inc. 2008 Senior Management Bonus Plan (incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed on August 11, 2008).+ |
| 10.13 | Restricted Stock Award Agreement dated May 3, 2007 between Pixelworks, Inc. and Hans H. Olsen (incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed August 9, 2007).+ |
| 10.14 | Offer letter dated June 22, 2007 between Pixelworks, Inc. and Steven L. Moore (incorporated by reference to Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q filed August 9, 2007).+ |
| 10.15 | Severance Agreement dated June 22, 2007, by and between Pixelworks, Inc. and Steven L. Moore (incorporated by reference to Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q filed August 9, 2007).+ |
| 10.16 | Change of Control Severance Agreement dated November 20, 2008, by and between Pixelworks, Inc. and Steven L. Moore (incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed November 20, 2008).+ |
| 10.17 | Change of Control Severance Agreement dated November 20, 2008, by and between Pixelworks, Inc. and Hongmin (Bob) Zhang (incorporated by reference to Exhibit 10.2 to the Company s Form 8-K filed November 20, 2008).+ |
| 10.18 | Intellectual Property Sublicense Agreement dated March 30, 1999 between VAutomation Incorporated and Pixelworks, Inc. (incorporated by reference to Exhibit 10.9 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000). |
| 10.19 | License Agreement dated February 22, 2000 between Pixelworks, Inc. and InFocus Systems, Inc. (incorporated by reference to Exhibit 10.10 to the Company s Registration Statement on Form S-1 declared effective May 19, 2000). |
| 10.20 | Office Lease dated June 20, 2005 and commencing March 1, 2006, by and between Pixelworks, Inc. and Union Bank of California as Trustee for Quest Group Trust VI (incorporated by reference to Exhibit 10.22 to the Company s Annual Report on Form 10-K filed March 12, 2007). |
| 10.21 | Office Lease dated October 2, 2007 and commencing November 1, 2007 by and between Pixelworks, Inc. and Union Bank of California as Trustee for Quest Group Trust VI (incorporated by reference to Exhibit 10.19 to the Company s Annual Report on Form 10-K filed March 12, 2008). |
| 10.22 | Amendment to Office Lease dated October 2, 2007 and commencing November 1, 2007 by and between Pixelworks, Inc. and Union Bank of California as Trustee for Quest Group Trust IV (incorporated by reference to Exhibit 10.2 the Company s Quarterly Report on Form 10-Q filed on November 7, 2008). |
| 10.23 | Office Lease Agreement dated December 2005, by and between CA-The Concourse Limited Partnership and Pixelworks, Inc. (incorporated by reference to Exhibit 10.42 to the Company s Annual Report on Form 10-K filed March 13, 2006). |
| 10.24 | Office Lease dated April 12, 2001, by and between Equator Technologies, Inc. and Pike Street Delaware, Inc. (incorporated by reference to Exhibit 10.18 to the Company s Quarterly Report on Form 10-Q filed August 9, 2005). |
| 10.25 | Amendment No. 1 to Office Lease dated July 7, 2005, by and between Equator Technologies, Inc. and 520 Pike Street, Inc. (incorporated by reference to Exhibit 10.20 to the Company s Quarterly Report on Form 10-Q filed November 7, 2005). |
| 10.26 | Office Lease Agreement dated September 10, 2008 and commencing December 1, 2008 by and between Pixelworks, Inc. and Durham Plaza, LLC (incorporated by reference to Exhibit 10.3 the Company s Quarterly Report on Form 10-Q filed on November 7, 2008). |

| | |
|---|---|
| 21 | Subsidiaries of Pixelworks, Inc. (incorporated by reference to Exhibit 21 to the Company s Quarterly Report on Form 10-Q filed November 7, 2008). |
| 23 | Consent of KPMG LLP. |
| 31.1 | Certification of Chief Executive Officer. |
| 31.2 | Certification of Chief Financial Officer. |

Table of Contents

| Exhibit Number | Description |
|---|---|
| 32.1* | Certification of Chief Executive Officer. |
| 32.2* | Certification of Chief Financial Officer. |

+ Indicates a management contract or compensation arrangement.

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

**SIGNATURES**

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

PIXELWORKS, INC.

By: /s/ Bruce A. Walicek
Bruce A. Walicek
*President and*
*Chief Executive Officer*

Dated: March 16, 2009

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ Bruce A. Walicek | President and Chief Executive Officer | March 16, 2009 |
| Bruce A. Walicek | | |
| /s/ Steven L. Moore | Vice President, Chief Financial Officer, Secretary and Treasurer | March 16, 2009 |
| Steven L. Moore | | |
| /s/ Allen H. Alley | Chairman of the Board | March 16, 2009 |
| Allen H. Alley | | |
| /s/ Mark A. Christensen | Director | March 16, 2009 |
| Mark A. Christensen | | |
| /s/ James R. Fiebiger | Director | March 16, 2009 |
| James R. Fiebiger | | |
| /s/ C. Scott Gibson | Director | March 16, 2009 |
| C. Scott Gibson | | |
| /s/ Daniel J. Heneghan | Director | March 16, 2009 |

| | | |
|---|---|---|
| Daniel J. Heneghan | | |
| /s/ Hans H. Olsen | Director | March 16, 2009 |
| Hans H. Olsen | | |
| /s/ Bruce A. Walicek | Director | March 16, 2009 |
| Bruce A. Walicek | | |