

PIXELWORKS, INC
Form 10-Q
November 07, 2008

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

(Mark One)

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

For the quarterly period ended September 30, 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

(State or other jurisdiction of incorporation)

91-1761992

(I.R.S. Employer Identification No.)

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

(Address of principal executive offices, including zip code,
and Registrant's telephone number, including area code)

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

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

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

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

Yes No

Number of shares of Common Stock outstanding as of October 31, 2008: 13,729,127

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008
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PIXELWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,780	\$ 74,572
Short-term marketable securities	18,560	34,581
Accounts receivable, net	5,948	6,223
Inventories, net	5,257	11,265
Prepaid expenses and other current assets	3,771	3,791
 Total current assets	 76,316	 130,432
 Long-term marketable securities	 1,490	 9,804
Property and equipment, net	4,839	6,148
Other assets, net	5,387	6,902
Debt issuance costs, net	764	2,260
Acquired intangible assets, net	4,091	6,370
 Total assets	 \$ 92,887	 \$ 161,916
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 4,541	\$ 3,992
Accrued liabilities and current portion of long-term liabilities	7,396	13,848
Current portion of income taxes payable		232
 Total current liabilities	 11,937	 18,072
 Long-term liabilities, net of current portion	 1,501	 1,236
Income taxes payable, net of current portion	10,866	10,635
Long-term debt	60,634	140,000
 Total liabilities	 84,938	 169,943
 Commitments and contingencies		
 Shareholders' equity (deficit):		
Preferred stock		

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Common stock	334,127	333,934
Shares exchangeable into common stock		113
Accumulated other comprehensive loss	(1,984)	(4,778)
Accumulated deficit	(324,194)	(337,296)
Total shareholders' equity (deficit)	7,949	(8,027)
Total liabilities and shareholders' equity	\$ 92,887	\$ 161,916

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Revenue, net	\$ 21,479	\$ 28,133	\$ 66,248	\$ 79,010
Cost of revenue (1)	10,028	16,025	32,628	45,447
Gross profit	11,451	12,108	33,620	33,563
Operating expenses:				
Research and development (2)	6,476	8,962	20,391	30,612
Selling, general and administrative (3)	4,413	5,697	13,590	20,235
Restructuring	121	1,645	971	7,048
Amortization of acquired intangible assets		89	164	269
Total operating expenses	11,010	16,393	35,116	58,164
Income (loss) from operations	441	(4,285)	(1,496)	(24,601)
Gain on repurchase of long-term debt, net	8,113		19,670	
Interest income	405	1,454	1,941	4,425
Interest expense	(343)	(658)	(1,335)	(2,003)
Amortization of debt issuance costs	(83)	(165)	(354)	(496)
Other income			218	
Other-than-temporary impairment of marketable security			(6,490)	
Interest and other income, net	8,092	631	13,650	1,926
Income (loss) before income taxes	8,533	(3,654)	12,154	(22,675)
Provision (benefit) for income taxes	314	775	(948)	1,796
Net income (loss)	\$ 8,219	\$ (4,429)	\$ 13,102	\$ (24,471)
Net income (loss) per share:				
Basic	\$ 0.57	\$ (0.27)	\$ 0.90	\$ (1.50)
Diluted	\$ 0.56	\$ (0.27)	\$ 0.89	\$ (1.50)
Weighted average shares outstanding:				
Basic	14,383	16,307	14,629	16,284

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Diluted	15,399	16,307	14,640	16,284
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(1) Includes:

Amortization of acquired developed technology	\$705	\$705	\$2,115	\$2,115
Stock-based compensation	8	22	46	70
Restructuring		11		147
(2) Includes stock-based compensation	177	538	1,075	1,718
(3) Includes stock-based compensation	227	684	965	2,633

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	September 30,	
	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ 13,102	\$ (24,471)
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)	
Other-than-temporary impairment of marketable security	6,490	
Depreciation and amortization	5,007	10,982
Amortization of acquired intangible assets	2,279	2,384
Stock-based compensation	2,086	4,421
Deferred income tax expense (benefit)	(476)	420
Amortization of debt issuance costs	354	496
Accretion on short- and long-term marketable securities	(325)	(320)
Loss on asset disposals	93	210
Write-off of certain assets related to restructuring	14	679
Other	40	41
Changes in operating assets and liabilities:		
Accounts receivable, net	275	646
Inventories, net	6,008	(1,703)
Prepaid expenses and other current and long-term assets, net	759	3,326
Accounts payable	(390)	(934)
Accrued current and long-term liabilities	(2,459)	(1,822)
Income taxes payable	(1)	(412)
Net cash provided by (used in) operating activities	13,186	(6,057)
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	43,964	52,221
Purchases of marketable securities	(22,999)	(27,837)
Purchases of property and equipment	(1,478)	(2,027)
Proceeds from sales of property and equipment	20	26
Net cash provided by investing activities	19,507	22,383
Cash flows from financing activities:		
Repurchase of long-term debt	(58,554)	
Payments on asset financings	(3,925)	(6,130)
Repurchase of common stock	(2,053)	
Proceeds from issuances of common stock	47	352

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Net cash used in financing activities	(64,485)	(5,778)
Net change in cash and cash equivalents	(31,792)	10,548
Cash and cash equivalents, beginning of period	74,572	63,095
Cash and cash equivalents, end of period	\$ 42,780	\$ 73,643

See accompanying notes to condensed consolidated financial statements.

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

NOTE 1: BASIS OF PRESENTATION

Nature of Business

We are an innovative designer, developer and marketer of video and pixel processing technology semiconductors and software for high-end digital video applications. Our solutions enable manufacturers of digital display and projection devices, such as multimedia projectors and large-screen liquid crystal display (LCD) televisions to differentiate their products with a consistently high level of video quality.

Condensed Consolidated Financial Statements

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

The financial information included herein for the three and nine month periods ended September 30, 2008 and 2007 is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows of the Company for these interim periods. The financial information as of December 31, 2007 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2007, included in Item 8 of our Annual Report on Form 10-K, filed with the SEC on March 12, 2008, and should be read in conjunction with such consolidated financial statements.

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

Use of Estimates

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

Reclassifications

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

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

Unrealized holding gains (losses) on short- and long-term available-for-sale securities, net of tax, were \$78 and \$(2,019), respectively, as of September 30, 2008 and \$(22) and \$(4,713), respectively, as of December 31, 2007. These unrealized holding gains and losses are recorded in accumulated other comprehensive loss, a component of shareholders' equity (deficit), in the condensed consolidated balance sheets. We determined that as of September 30, 2008, gross unrealized losses on our marketable securities were temporary based on our intent and ability to hold the investments until recovery.

Accounts Receivable, Net

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

	September 30, 2008	December 31, 2007
Accounts receivable, gross	\$ 6,490	\$ 6,765
Less: allowance for doubtful accounts	(542)	(542)
Accounts receivable, net	\$ 5,948	\$ 6,223

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

	Nine Months Ended September 30,	
	2008	2007
Balance at beginning of period	\$ 542	\$ 200
Provision		483
Recoveries		(96)
Balance at end of period	\$ 542	\$ 587

Inventories, Net

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

Inventories, net consists of the following:

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	September 30, 2008	December 31, 2007
Finished goods	\$ 4,928	\$ 12,733
Work-in-process	5,412	4,482
	10,340	17,215
Less: reserve for slow-moving and obsolete items	(5,083)	(5,950)
Inventories, net	\$ 5,257	\$ 11,265

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

	Nine Months Ended September 30,	
	2008	2007
Balance at beginning of period	\$ 5,950	\$ 5,950
Provision	1,361	3,834
Usage:		
Sales	(836)	(1,408)
Scrap	(1,392)	(1,551)
Total usage	(2,228)	(2,959)
Balance at end of period	\$ 5,083	\$ 6,825

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 September 30, 2008. However, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. It is not possible for us to predict if or when this may happen, or how much we may sell. If such sales occur, we do not expect that they will have a material effect on gross profit margin.

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. In the third quarter of 2008 we increased the estimated amortization rate of a certain prepaid royalty due to a change in future product design. The revision will be made prospectively and had no impact on our condensed statements of operations, balance sheets or cash flows as of September 30, 2008.

Property and Equipment, Net

Property and equipment, net consists of the following:

	September 30, 2008	December 31, 2007
Gross carrying amount	\$ 18,685	\$ 17,109
Less: accumulated depreciation and amortization	(13,846)	(10,961)
Property and equipment, net	\$ 4,839	\$ 6,148

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Acquired intangible assets, net consists of the following:

	September 30, 2008	December 31, 2007
Gross carrying amount:		
Developed technology	\$ 19,170	\$ 19,170
Customer relationships	1,689	1,689
	20,859	20,859
Less accumulated amortization:		
Developed technology	(15,079)	(12,964)
Customer relationships	(1,689)	(1,525)
	(16,768)	(14,489)
Acquired intangible assets, net	\$ 4,091	\$ 6,370

Estimated future amortization of acquired developed technology is as follows:

Three Months Ending December 31:	
2008	\$ 705
Year Ending December 31:	
2009	2,336
2010	1,050
	\$ 4,091

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	September 30, 2008	December 31, 2007
Accrued payroll and related liabilities	\$ 3,535	\$ 3,366
Reserve for warranty returns	678	932
Accrued costs related to restructuring	487	2,918
Current portion of accrued liabilities for asset financings	428	4,150
Accrued interest payable	416	405
Accrued commissions and royalties	249	381
Reserve for sales returns and allowances	175	175
Other	1,428	1,521
	\$ 7,396	\$ 13,848

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

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	Nine Months Ended September 30,	
	2008	2007
Reserve for warranty returns:		
Balance at beginning of period	\$ 932	\$ 662
Provision	(73)	1,203
Charge offs	(181)	(959)
Balance at end of period	\$ 678	\$ 906
Reserve for sales returns and allowances:		
Balance at beginning of period	\$ 175	\$ 479
Provision	74	111
Charge offs	(74)	(415)
Balance at end of period	\$ 175	\$ 175

Long-Term Debt

In 2004, we issued \$150,000 of 1.75% convertible subordinated debentures (the debentures) due 2024. In February 2006, we repurchased and retired \$10,000 of the debentures. In February 2008, we repurchased and retired \$50,248 of the debentures in a modified dutch auction tender offer for \$37,939 in cash. We recognized a net gain of \$11,557 on the repurchase, which included a \$13,064 discount, offset by legal and professional fees of \$755 and a write-off of debt issuance costs of \$752. 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 \$8,113 on the repurchases, which included an \$8,503 discount, offset by a write-off of debt issuance costs of \$390.

The remaining \$60,634 of debentures are convertible, under certain circumstances, into our common stock at a conversion rate of 13.6876 shares of common stock per \$1 principal amount of debentures for a total of 829,934 shares. This is equivalent to a conversion price of approximately \$73.06 per share. The debentures are convertible if (a) our stock trades above 130% of the conversion price for 20 out of 30 consecutive trading days during any calendar quarter, (b) the debentures trade at an amount less than or equal to 98% of the if-converted value of the debentures for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other specified corporate transactions.

We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the \$60,634 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.

Shareholders Equity (Deficit)**Reverse Stock Split**

On June 4, 2008, we effected a one-for-three reverse split of our common stock. The exercise price and number of shares of common stock issuable under our stock incentive plans, as well as the conversion price and number of shares issuable upon conversion of our long-term debt were proportionately adjusted

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to reflect the reverse stock split. Basic and diluted weighted average shares outstanding and earnings per share have been calculated to reflect the reverse stock split in all periods presented.

Share Repurchase Program

In September 2007, the Board of Directors authorized the repurchase of up to \$10,000 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 2007, we repurchased 1,260,833 common shares at a cost of \$4,269. During the first nine months of 2008, we repurchased 1,031,437 shares for \$2,053. As of September 30, 2008, \$3,678 remained available for repurchase under the plan. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

NOTE 3: FAIR VALUE MEASUREMENT

On January 1, 2008, we adopted FASB Statement of Financial Accounting Standard No. (SFAS) 157, *Fair Value Measurement* (SFAS 157) for our financial assets and liabilities. SFAS 157 defines fair value and describes three levels of inputs that may be used to measure fair value:

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

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

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

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

	Level 1	Level 2	Level 3	Total
Cash equivalents	\$ 29,026	\$	\$	\$ 29,026
Short-term marketable securities		18,560		18,560
Long-term marketable securities	1,490			1,490
Total	\$ 30,516	\$ 18,560	\$	\$ 49,076

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

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

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

NOTE 4: RESTRUCTURING PLANS

In 2006, we initiated restructuring plans aimed at returning the Company to profitability. We continued to implement these plans throughout 2007 and 2008. Restructuring expense related to these plans was as follows:

	Nine Months Ended September 30, 2008	Cumulative Amount Incurred To September 30, 2008
Cost of revenue restructuring:		
Termination and retention benefits	\$	\$ 219
Licensed technology and tooling write-offs		2,072
		2,291
Operating expenses restructuring:		
Consolidation of leased space	508	3,068
Termination and retention benefits	463	8,445
Net write-off of assets and reversal of related liabilities		13,451
Contract termination fee		1,693
Payments, non-cancelable contracts		827
Other		88
	971	27,572
Total restructuring expense	\$ 971	\$ 29,863

The following is a summary of the change in accrued liabilities related to our restructuring plans:

	Balance as of December 31, 2007	Expensed	Payments	Balance as of September 30, 2008
Termination and retention benefits	\$ 1,758	\$ 463	\$ (2,130)	\$ 91
Lease termination costs	999	508	(827)	680
Contract termination and other costs	514		(514)	
Total	\$ 3,271	\$ 971	\$ (3,471)	\$ 771

NOTE 5: INCOME TAXES

The provision (benefit) for income taxes recorded for the three and nine month periods ended September 30, 2008 and 2007 includes current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. Additionally, during the first quarter of 2008,

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we recorded a benefit of \$1,000 for refundable research and experimentation credits, a benefit of \$559 for the reversal of a previously recorded tax contingency due to the expiration of the applicable statute of limitations, and a deferred tax benefit of \$446 which resulted from an increase in the tax rate of a single foreign jurisdiction.

As of September 30, 2008, we continued to provide a full valuation allowance against essentially all of our U.S. and Canadian net deferred tax assets as we do not believe that it is more likely than not that we will realize a benefit from those assets. We have not recorded a valuation allowance against our other foreign net deferred tax assets as we believe that it is more likely than not that we will realize a benefit from those assets.

As of September 30, 2008 and December 31, 2007, the amount of our uncertain tax positions was a liability of \$10,866 and \$10,635, respectively. A number of years may elapse before an uncertain tax position is resolved by settlement or statute of limitations. Settlement of any particular position could require the use of cash. If the uncertain tax positions we have accrued for are sustained by the taxing authorities in our favor, the reduction of the liability will reduce our effective tax rate. We reasonably expect reductions in the liability for unrecognized tax benefits of approximately \$2,149 within the next twelve months due to the expiration of the statute of limitations in foreign jurisdictions. We recognize interest and penalties related to uncertain tax positions in income tax expense in our consolidated statement of operations.

NOTE 6: COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Net income (loss)	\$ 8,219	\$ (4,429)	\$ 13,102	\$ (24,471)
Reclassification adjustment from accumulated other comprehensive income for other-than-temporary loss on marketable security included in net income			4,810	
Unrealized loss on available-for-sale investments	(1,469)	(797)	(2,016)	(346)
Total comprehensive income (loss)	\$ 6,750	\$ (5,226)	\$ 15,896	\$ (24,817)

NOTE 7: EARNINGS PER SHARE

We calculate earnings per share in accordance with SFAS 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and include exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 by Jaldi, our Canadian subsidiary, to its shareholders in connection with the Jaldi asset acquisition, have characteristics essentially equivalent to Pixelworks common stock. As of January 31, 2008 all exchangeable shares had been exchanged for shares of Pixelworks, Inc. 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 incremental number of common shares that would be outstanding assuming the exercise of certain stock options, when such exercise would have the effect of reducing earnings per share, and the conversion of our convertible debentures, using the

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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.

The following schedule reconciles the computation of basic net income per share and diluted net income per share for periods presented in which basic weighted average shares outstanding were not equal to diluted weighted average shares outstanding (in thousands, except per share data):

	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008	
Net income used in basic net income per share	\$	8,219	\$	13,102
Interest expense on long-term debt, net of tax and amortization of debt issuance costs, net of tax		408		
Net income used in diluted net income per share	\$	8,627	\$	13,102
Basic weighted average shares outstanding		14,383		14,629
Common share equivalents:				
Dilutive effect of stock options		9		11
Dilutive effect of conversion of long-term debt		1,007		
Diluted weighted average shares outstanding		15,399		14,640
Basic net income per common share	\$	0.57	\$	0.90
Diluted net income per common share	\$	0.56	\$	0.89

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

	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008	
		2007		2007
Stock options	1,828	1,909	1,753	2,045
Conversion of debentures		1,916	1,312	1,916
Unvested stock awards		47		27
	1,828	3,872	3,065	3,988

NOTE 8: SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental disclosure of cash flow information is as follows:

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	Nine Months Ended September 30,	
	2008	2007
Cash paid during the period for:		
Interest	\$1,341	\$1,388
Income taxes	46	101
Non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	\$1,138	\$ 395

NOTE 9: SEGMENT INFORMATION

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

Geographic Information

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Japan	\$ 12,728	\$ 15,490	\$ 38,974	\$ 43,684
Taiwan	3,745	3,653	7,809	9,476
Europe	1,254	1,583	5,596	4,650
U.S.	1,047	1,178	2,902	3,700
Korea	829	2,108	4,438	6,386
China	305	2,014	1,415	4,837
Other	1,571	2,107	5,114	6,277
	\$ 21,479	\$ 28,133	\$ 66,248	\$ 79,010

Significant Customers

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

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Distributors:				
All distributors	54%	52%	51%	57%
Distributor A	35%	29%	31%	32%
End Customers: ⁽¹⁾				
Top five end customers	55%	53%	55%	47%
End customer A	22%	25%	25%	21%
End customer B	12%	4%	8%	5%

⁽¹⁾: End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and manufacturers representatives.

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

	September 30, 2008	December 31, 2007
Account A	25%	21%
Account B	22%	27%
Account C	11%	7%

NOTE 10: RISKS AND UNCERTAINTIES**Concentration of Suppliers**

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

Risk of Technological Change

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

Concentrations of Credit Risk

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

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exposure to credit risk associated with accounts receivable by carefully evaluating creditworthiness before offering terms to customers.

NOTE 11: COMMITMENTS AND CONTINGENCIES

Indemnifications

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

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

Forward-looking Statements

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

Overview

We are an innovative designer, developer and marketer of video and pixel processing technology semiconductors and software for high-end digital video applications. Our solutions enable manufacturers of digital display and projection devices, such as multimedia projectors and large-screen LCD televisions to differentiate their products with a consistently high level of video quality.

Table of Contents**Results of Operations****Revenue, net**

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

	Three months ended		2008 v 2007		% of net revenue	
	September 30,					
	2008	2007	\$ change	% change	2008	2007
Multimedia projector	\$ 14,336	\$ 16,466	\$ (2,130)	(13)%	67%	59%
Advanced television	2,762	5,515	(2,753)	(50)	13	20
Advanced media processor	2,595	3,790	(1,195)	(32)	12	13
LCD monitor, panel and other	1,786	2,362	(576)	(24)	8	8
Total revenue	\$ 21,479	\$ 28,133	\$ (6,654)	(24)%	100%	100%

	Nine months ended		2008 v 2007		% of net revenue	
	September 30,					
	2008	2007	\$ change	% change	2008	2007
Multimedia projector	\$ 41,251	\$ 42,686	\$ (1,435)	(3)%	62%	54%
Advanced television	8,759	15,738	(6,979)	(44)	13	20
Advanced media processor	9,016	12,373	(3,357)	(27)	14	16
LCD monitor, panel and other	7,222	8,213	(991)	(12)	11	10
Total revenue	\$ 66,248	\$ 79,010	\$ (12,762)	(16)%	100%	100%

Multimedia Projector

Revenue from the multimedia projector market decreased 13% in the third quarter of 2008 compared to the third quarter of 2007. This decrease is due to an 11% decrease in units sold and a 2% decrease in average selling price (ASP). Multimedia projector revenue in the first nine months of 2008 decreased 3% compared to the first nine months of 2007. This decline is due to a 2% decrease in units sold and a 1% decrease in ASP.

Advanced Television

Revenue from the advanced television market decreased 50% in the third quarter of 2008 compared to the third quarter of 2007. This decrease is due to a 62% decrease in units sold partially off-set by a 33% increase in ASP. Revenue from the advanced television market decreased 44% in the first nine months of 2008 compared to the first nine months of 2007. This decrease is due to a 51% decrease in units sold, partially off-set by a 14% increase in ASP. Revenue decreases in the 2008 periods are primarily due to our decision to shift focus away from the commoditized System on Chip segment of the advanced television market. With our new strategy we are developing co-processor ICs designed to improve the video performance of any image processor in the large screen, high resolution, high quality segment of the advanced television market. The increase in ASP during the 2008 periods is primarily attributable to a shift in the mix of products sold.

Advanced Media Processor

Revenue in the advanced media processor market is attributable to products we obtained in connection with our acquisition of Equator Technologies, Inc. (Equator) in June 2005. Revenue from this market

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decreased 32% in the third quarter of 2008 compared to the third quarter of 2007. This decrease resulted from a 52% decrease in units sold, partially off-set by a 43% increase in ASP. Revenue from this market decreased 27% in the first nine months of 2008 compared to the first nine months of 2007. This decrease resulted from a 35% decrease in units sold, partially offset by a 13% increase in ASP.

As a result of our April 2006 restructuring plan we are no longer pursuing stand-alone digital media streaming markets that are not core to our business. We expect to see revenue from this market continue to decrease over time as customers switch to next generation designs from other suppliers. The increase in ASP during the 2008 periods is primarily attributable to a change in our customer mix.

LCD Monitor, Panel and Other

LCD monitor, panel and other revenue decreased \$576,000, or 24% in the third quarter of 2008 compared to the third quarter of 2007, and decreased \$991,000, or 12% in the first nine months of 2008 compared to the first nine months of 2007. The decrease is primarily attributable to our decision to stop focusing our development efforts on these markets.

Cost of revenue and gross profit

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

	Three months ended September 30,			
	2008	% of revenue	2007	% of revenue
Direct product costs and related overhead ¹	\$ 9,450	44%	\$ 14,283	51%
Provision for obsolete inventory, net of usage	(135)	(1)	1,004	4
Amortization of acquired developed technology	705	3	705	3
Restructuring			11	0
Stock-based compensation	8	0	22	0
Total cost of revenue	\$ 10,028	47%	\$ 16,025	57%
Gross profit	\$ 11,451	53%	\$ 12,108	43%

	Nine months ended September 30,			
	2008	% of revenue	2007	% of revenue
Direct product costs and related overhead ¹	\$ 29,942	45%	\$ 40,689	51%
Provision for obsolete inventory, net of usage	525	1	2,426	3
Amortization of acquired developed technology	2,115	3	2,115	3
Restructuring			147	0
Stock-based compensation	46	0	70	0
Total cost of revenue	\$ 32,628	49%	\$ 45,447	58%
Gross profit	\$ 33,620	51%	\$ 33,563	42%

¹ Includes purchased materials, assembly, test,

labor, employee
benefits,
warranty
expense and
royalties.

Direct product costs and related overhead decreased to 44% and 45% of revenue in the third quarter and first nine months of 2008, respectively, down from 51% in the third quarter and first nine months of 2007.

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The decrease in direct product costs and related overhead as a percentage of revenue in the 2008 periods compared to the 2007 periods resulted primarily from a more favorable mix of products sold and also from lower pricing obtained from vendors and increases in production yields. The net provision for obsolete inventory decreased to (1)% of revenue in the third quarter of 2008 from 4% in the third quarter of 2007, and to 1% of revenue in the first nine months of 2008 from 3% in the first nine months of 2007. The decrease in the net provision for obsolete inventory as a percentage of revenue in the 2008 periods compared to 2007 periods is attributable to our increased focus on inventory management.

Research and development

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

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

	Three months ended September 30,		2008 v 2007	
	2008	2007	\$ change	% change
Research and development ¹	\$6,476	\$8,962	\$(2,486)	(28)%

¹ Includes stock-based compensation expense of: 177 538

Research and development expense decreased 28% in the third quarter of 2008 compared with the third quarter of 2007. The decrease in research and development expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

Depreciation and amortization expense decreased \$1.4 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 \$543,000. At September 30, 2008, we had 130 research and development employees compared to 188 at September 30, 2007.

Stock-based compensation expense decreased \$361,000 due to personnel reductions and reduced valuation of our stock options.

Facilities and information technology expense allocations decreased \$294,000, primarily due to decreases in equipment depreciation and compensation expense.

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

	Nine months ended September 30,		2008 v 2007	
	2008	2007	\$ change	% change
Research and development ¹	\$20,391	\$30,612	\$(10,221)	(33)%

¹ Includes stock-based compensation expense of: 1,075 1,718

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Research and development expense decreased 33% in the first nine months of 2008 compared with the first nine months of 2007. The decrease in research and development expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

Depreciation and amortization expense decreased \$5.2 million. This decrease is primarily due to the December 31, 2007 write-off of engineering software tools.

Compensation expense decreased \$2.3 million due to fewer research and development personnel.

Facilities and information technology expense allocations decreased \$1.4 million, primarily due to reductions in outsourced IT support, lower rent and decreased equipment depreciation.