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

FORM 10-Q

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

For the quarterly period ended March 31, 2005

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

8100 SW Nyberg Road
Tualatin, Oregon 97062
(503) 454-1750
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

Number of shares of Common Stock outstanding as of April 30, 2005: **46,496,945**

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2005

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

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

	March 31, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 50,542	$ 32,585
Short-term marketable securities	166,073	160,213
Accounts receivable, net	15,205	14,605
Inventories, net	13,580	18,575
Prepaid expenses and other current assets	5,468	4,856
Total current assets	250,868	230,834
Long-term marketable securities	53,407	79,483
Property and equipment, net	12,243	12,444
Other assets, net	11,246	8,101
Debt issuance costs, net	4,310	4,483
Deferred tax assets, net	4,868	4,868
Acquired intangible assets, net	2,266	2,520
Goodwill	80,836	80,836
Total assets	$ 420,044	$ 423,569
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,861	$ 5,946
Accrued liabilities and current portion of long-term liabilities	11,712	12,842
Income taxes payable	853	2,393
Total current liabilities	17,426	21,181
Long-term liabilities	297	365
Long-term debt	150,000	150,000
Total liabilities	167,723	171,546
Shareholders' equity		
Preferred stock	—	—
Common stock	306,216	304,996
Shares exchangeable into common stock	6,004	6,144
Accumulated other comprehensive (loss) income	(1,102)	531
Deferred stock-based compensation	(45)	(60)
Accumulated deficit	(58,752)	(59,588)
Total shareholders' equity	252,321	252,023
Total liabilities and shareholders' equity	$ 420,044	$ 423,569

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Revenue	$ 40,261	$ 45,270
Cost of revenue (1)	23,343	21,883
Gross profit	16,918	23,387
Operating expenses:		
Research and development (2)	9,442	7,704
Selling, general and administrative (3)	7,068	5,474
Stock-based compensation and amortization of assembled workforce	137	285
Total operating expenses	16,647	13,463
Income from operations	271	9,924
Interest income	1,715	236
Interest expense	(657)	(1)
Amortization of debt issuance costs	(177)	—
Interest income, net	881	235
Income before income taxes	1,152	10,159
Provision for income taxes	316	3,606
Net income	$ 836	$ 6,553
Net income per share:		
Basic	$ 0.02	$ 0.14
Diluted	$ 0.02	$ 0.14
Weighted average shares outstanding:		
Basic	46,969	46,320
Diluted	47,887	48,141

(1) Includes amortization of acquired developed technology of:	$ 132	$ 132
(2) Excludes stock-based compensation of:	11	80
(3) Excludes stock-based compensation of:	4	84

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Cash flows from operating activities:		
Net income	$ 836	$ 6,553
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,861	1,428
Income tax benefit from stock options	242	—
(Gain) loss on asset disposals	(1)	163
Amortization of acquired developed technology	132	132
Stock-based compensation and amortization of assembled workforce	137	285
Amortization of debt issuance costs	177	—
Amortization of deferred tax charge	14	14
Deferred rent	4	3
Changes in operating assets and liabilities:		
Accounts receivable, net	(600)	(8,614)
Inventories, net	4,995	699
Prepaid expenses and other current and long-term assets, net	(1,106)	1,276
Accounts payable	(1,069)	4,894
Accrued current and long-term liabilities and income taxes payable	(3,011)	2,977
Net cash provided by operating activities	3,611	9,810
Cash flows from investing activities:		
Purchases of marketable securities	(36,345)	(4,837)
Purchases of property and equipment	(2,123)	(975)
Payments on asset financing	(1,027)	(1)
Purchases of other assets	(1,921)	(786)
Proceeds from maturities of marketable securities	54,928	10,750
Net cash provided by investing activities	13,512	4,151
Cash flows from financing activities:		
Proceeds from issuances of common stock	838	2,706
Debt issuance costs	(4)	—
Tenant improvement allowance	—	62
Net cash provided by financing activities	834	2,768
Net increase in cash and cash equivalents	17,957	16,729
Cash and cash equivalents, beginning of period	32,585	16,490
Cash and cash equivalents, end of period	$ 50,542	$ 33,219
Supplemental disclosure of cash flow information:		
Cash paid for:		
Income taxes	$ 1,600	$ 1
Interest	—	1
Supplemental disclosure of non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	$ 1,296	$ —
Transfer of cost-based investment to available-for-sale marketable security	—	10,000

See accompanying notes to condensed consolidated financial statements.

NOTE 1: BASIS OF PRESENTATION

Nature of Business

Pixelworks, Inc. ("Pixelworks" or the "Company") is a leading designer, developer and marketer of semiconductors and software for the advanced display industry, including advanced televisions, multimedia projectors and flat panel monitors. Our system-on-chip semiconductors provide the 'intelligence' for these types of displays by processing and optimizing video and computer graphic signals to produce high-quality images.

Condensed Consolidated Financial Statements

These condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. 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 months ended March 31, 2005 and 2004 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, 2004 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2004, included in Item 8 of our Annual Report on Form 10-K, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2005.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires us to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. Our significant estimates and judgments include those related to product returns, warranty obligations, bad debts, inventory valuation, property and equipment, intangible assets and income taxes. The actual results experienced by the Company could differ materially from our estimates.

Reclassifications

Certain reclassifications have been made to the 2004 condensed consolidated financial statements to conform to the 2005 presentation, including the reclassification of investments in auction rate securities from cash and cash equivalents to available-for-sale short-term marketable securities and the reclassification of tooling depreciation from research and development expense to cost of revenue. Additionally, facilities and information technology expenses have been allocated between selling, general and administrative expense, research and development expense and cost of revenue based on employee headcount.

NOTE 2: STOCK PLANS

We have a 1997 Stock Incentive Plan and a 2001 Nonqualified Stock Option Plan under which employees, officers and directors may be granted stock options to purchase shares of the Company's common stock. We also have a 2000 Employee Stock Purchase Plan under which eligible employees may purchase shares of Pixelworks' common stock at 85% of fair market value at specific, pre-determined dates.

As permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), and SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an Amendment of FASB Statement No. 123*, we continue to apply the intrinsic value based method of accounting for stock compensation described in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"). As such, stock-based compensation cost is measured as the excess, if any, of the quoted market price of Pixelworks' stock on the grant, or other measurement date, over the amount that an option holder must pay to acquire the stock.

Entities electing to continue to apply Opinion 25 must make prominent pro-forma disclosures of net income and earnings per share as if the fair value based method prescribed by SFAS 123 had been applied. Had we accounted for our stock-based compensation plans in accordance with SFAS 123, our net income (loss) would have approximated the pro-forma amounts below:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Net income as reported	$ 836	$ 6,553
Add: Stock-based compensation included in reported net income, net of related tax effects	11	100
Deduct: Stock-based compensation determined under the fair value based method, net of related tax effects	(2,719)	(2,095)
Pro-forma net (loss) income	$ (1,872)	$ 4,558
Reported basic net income per share	$ 0.02	$ 0.14
Pro-forma basic net (loss) income per share	$ (0.04)	$ 0.10
Reported diluted net income per share	$ 0.02	$ 0.14
Pro-forma diluted net (loss) income per share	$ (0.04)	$ 0.10

The fair value of stock-based compensation costs reflected in the above pro-forma amounts were determined using the Black-Scholes option pricing model and the following weighted average assumptions:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Stock Option Plans:		
Risk free interest rate	4.08%	3.51%
Expected dividend yield	0%	0%
Expected life (in years)	7.3	6.1
Volatility	96%	103%
Employee Stock Purchase Plan:		
Risk free interest rate	2.00%	1.90%
Expected dividend yield	0%	0%
Expected life (in years)	0.8	1.6
Volatility	92%	104%

The effects of applying SFAS 123 in this pro-forma disclosure are not indicative of future amounts and additional awards are anticipated in future periods.

NOTE 3: BALANCE SHEET COMPONENTS

Marketable Securities

At December 31, 2004, we classified all marketable securities as held-to-maturity in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS 115"), with the exception of auction rate securities and our investment in Semiconductor Manufacturing International Corporation ("SMIC"), which we classified as available-for-sale.

On March 31, 2005, we determined that we no longer had the intent to hold any of our securities to maturity based on the potential for future acquisitions, and we reclassified all of our held-to-maturity securities to available-for-sale. The amortized cost of the securities transferred from held-to-maturity to available-for-sale was $159,632 on the March 31, 2005 transfer date.

Short-term marketable securities were classified as follows:

	March 31, 2005	December 31, 2004
Available-for-sale	$ 166,073	$ 77,150
Held-to-maturity	—	83,063
	$ 166,073	$ 160,213

Long-term marketable securities were classified as follows:

	March 31, 2005	December 31, 2004
Available-for-sale	$ 53,407	$ 10,531
Held-to-maturity	—	68,952
	$ 53,407	$ 79,483

Unrealized holding losses on short-term available-for-sale marketable securities, net of tax, were $571 at March 31, 2005. Unrealized holding losses on long-term available-for-sale marketable securities, net of tax, were $531 at March 31, 2005. These unrealized holding losses are recorded in accumulated other comprehensive loss, a component of shareholders' equity, at March 31, 2005.

There were no unrealized holding gains or losses on available-for-sale auction rate securities at December 31, 2004, and the unrealized holding gain on our investment in SMIC at December 31, 2004, net of tax, was $531. This unrealized holding gain was recorded in accumulated other comprehensive income at December 31, 2004.

Gross unrealized holding losses on short-term held-to-maturity marketable securities were $48 at December 31, 2004, and gross unrealized losses on long-term held-to-maturity marketable securities were $68 at December 31, 2004.

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 consisted of the following:

	March 31, 2005	December 31, 2004
Accounts receivable, gross	$ 15,417	$ 14,817
Allowance for doubtful accounts	(212)	(212)
	$ 15,205	$ 14,605

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 consisted of the following:

	March 31, 2005	December 31, 2004
Finished goods	$ 8,272	$ 11,648
Work-in-process	6,749	8,516
	15,021	20,164
Reserve for slow moving and obsolete items	(1,441)	(1,589)
	$ 13,580	$ 18,575

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

	Three Months Ended March 31, 2005	2004
Beginning balance	$ 1,589	$ 1,942
Provision	8	(533)
Charge offs	(156)	(95)
Ending balance	$ 1,441	$ 1,314

While we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand at March 31, 2005 based upon our forecast and backlog, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. It is not currently possible to predict if or when this will happen, or how much we may sell. We do not expect that if such sales occur, they will have a material impact on gross profit margin.

Property and Equipment, Net

Property and equipment, net consisted of the following:

	March 31, 2005	December 31, 2004
Gross carrying amount of assets	$ 36,300	$ 34,193
Accumulated depreciation and amortization	(24,057)	(21,749)
	$ 12,243	$ 12,444

Acquired Intangible Assets, Net

Acquired intangible assets, net consisted of the following:

	March 31, 2005	December 31, 2004
Gross carrying amount of assets	$ 5,277	$ 5,277
Accumulated amortization	(3,011)	(2,757)
	$ 2,266	$ 2,520

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	March 31, 2005	December 31, 2004
Accrued payroll and related liabilities	$ 3,074	$ 4,586
Current portion of accrued liabilities for asset financing	3,446	3,185
Accrued interest payable	992	335
Accrued commissions and royalties	816	719
Accrued manufacturing liabilities	810	477
Reserve for warranty returns	463	419
Reserve for sales returns and allowances	352	524
Other	1,759	2,597
	$ 11,712	$ 12,842

The following is a summary of the change in our reserve for sales returns and allowances for the three months ended March 31, 2005 and 2004:

	Three Months Ended March 31,	
	2005	2004
Beginning balance	$ 524	$ 202
Provision	73	57
Charge offs	(245)	(2)
Ending balance	$ 352	$ 257

The following is a summary of the change in our reserve for warranty returns for the three months ended March 31, 2005 and 2004:

	Three Months Ended March 31,	
	2005	2004
Beginning balance	$ 419	$ 569
Provision	127	(21)
Charge offs	(83)	(15)
Ending balance	$ 463	$ 533

Long-Term Debt

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 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 bear interest at a rate of 1.75% per annum and interest is payable on May 15 and November 15 of each year, beginning November 15, 2004. The debentures are convertible, under certain circumstances, into our common stock at a conversion rate of 41.0627 shares of common stock per $1,000 principal amount of debentures for a total of 6,159 shares. This is equivalent to a conversion price of approximately $24.35 per share. The debentures are convertible if (a) during any calendar quarter, the market price of our common stock exceeds 130% of the conversion price per share for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the previous calendar quarter, (b) the trading price of the debentures declines to less than 98% of the product of the closing sale price of our common stock and the number of shares issuable upon conversion of $1,000 principal amount of the debentures for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other 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.

We have filed a shelf registration statement with the Securities and Exchange Commission covering resales of the debentures and the common stock issuable upon conversion of the debentures. The registration statement was declared effective August 24, 2004. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

NOTE 4: COMPREHENSIVE (LOSS) INCOME

Total comprehensive (loss) income for the three months ended March 31, 2005 and 2004 was as follows:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Net income	$ 836	$ 6,553
Unrealized (loss) gain on available-for-sale investments, net of tax	(1,633)	3,315
Comprehensive (loss) income	$ (797)	$ 9,868

NOTE 5: EARNINGS PER SHARE

We calculate earnings per share in accordance with SFAS No. 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and includes 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.

Diluted weighted average shares outstanding includes the increased number of common shares that would be outstanding assuming the exercise of certain stock options and the vesting of certain restricted stock, when such exercise or vesting would have the effect of reducing earnings per share. In the fourth quarter of 2004, we adopted Emerging Issues Task Force Issue No. 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings per Share.* As a result, diluted weighted average shares outstanding also includes the increased number of common shares that would be outstanding assuming the conversion of our convertible debentures, using the if-converted method, when such conversion would have the effect of reducing earnings per share. The common shares issuable upon conversion of the debentures have been excluded from weighted average dilutive common shares outstanding for the three months ended March 31, 2005, as their inclusion would have the effect of increasing earnings per share.

The following schedule reconciles basic and diluted weighted average shares outstanding:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Weighted average common shares outstanding, basic	46,969	46,320
Dilutive effect of employee stock options and vesting of restricted stock	918	1,821
Weighted average common shares outstanding, diluted	47,887	48,141

For the three months ended March 31, 2005 and 2004, respectively, approximately 4,551 and 1,271 weighted average shares related to stock options were also excluded from the calculation of diluted weighted average shares outstanding because the exercise prices of these options were equal to or greater than the average market price of Pixelworks common stock during these periods, and as a result, their inclusion would have been anti-dilutive.

NOTE 6: SEGMENT INFORMATION

In accordance with SFAS No. 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 electronic display devices. Substantially all of our assets are located in the United States.

Geographic Information

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

	Three Months Ended March 31,	
	2005	2004
Japan	$ 13,754	$ 17,441
Taiwan	10,355	11,643
Europe	6,289	2,378
China	4,989	6,808
Korea	3,788	4,274
U.S.	484	585
Other	602	2,141
	$ 40,261	$ 45,270

Significant Customers

Sales to distributors represented 54% and 71% of total revenue for the three months ended March 31, 2005 and 2004, respectively. The following distributors accounted for 10% or more of total revenue for certain of the periods presented:

	Three Months Ended March 31,	
	2005	2004
Distributor A	24%	31%
Distributor B	5%	17%

Sales to our top five end customers represented 36% and 37% of total revenue for the three months ended March 31, 2005 and 2004, respectively.

The following end customers accounted for 10% or more of total revenue for certain of the periods presented:

	Three Months Ended March 31,	
	2005	2004
Customer A	10%	1%
Customer B	4%	12%

End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and contract manufacturers.

The following accounts represented 10% or more of gross accounts receivable:

	March 31, 2005	December 31, 2004
Account A	18%	11%
Account B	13%	26%

NOTE 7: 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 four third-party foundries to produce all of our products and 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 growth and results of operations.

Risk of Technological Change

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

Concentrations of Credit Risk

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

NOTE 8: COMMITMENTS AND CONTINGENCIES

Indemnifications

Certain of our software license agreements include limited indemnification provisions for claims from third-parties relating to our intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5, *Accounting for Contingencies*. The indemnification is limited to the amount paid by the customer. As of March 31, 2005, we have not incurred any material liabilities arising from these indemnification obligations, however in the future, such obligations could impact our immediate results of operations but would not materially affect our business.

NOTE 9: SUBSEQUENT EVENT

On April 28, 2005, we entered into an Agreement and Plan of Merger with Equator Technologies, Inc. (“Equator”). Equator is a leading provider of programmable digital video and audio encoding and decoding solutions with a family of Broadband Signal Processor integrated circuits. Under the terms of the merger agreement, we will purchase all outstanding shares of Equator for approximately $109 million in cash. Additionally, all outstanding Equator stock options will be converted into options to acquire Pixelworks common stock. The transaction is expected to close in the second quarter of 2005 and is subject to regulatory approval and customary closing conditions. The transaction will be accounted for by the purchase method of accounting, and accordingly, the results of operations of Equator will be included in our financial statements beginning on the date of closing.

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 and other sections of this Report contain "forward-looking statements" within the meaning of the Securities Litigation Reform Act of 1995 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, increased competition, continued adverse economic conditions in the U.S. and internationally, including adverse economic conditions in the specific markets for our products, adverse business conditions, failure to design, develop and manufacture new products, lack of success in technological advancements, lack of acceptance of new products, 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 and our ability to attract, hire and retain key and qualified employees. 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.

(Dollars in thousands)

Overview

We are a leading designer, developer and marketer of semiconductors and software for the advanced display industry, including advanced televisions, multimedia projectors and flat panel monitors. Our system-on-chip semiconductors provide the 'intelligence' for these new types of displays by processing and optimizing video and computer graphic signals to produce high-quality and realistic images. Many of the world's leading manufacturers of consumer electronics and computer display products utilize our technology to enhance image quality and ease of use of their products. Our goal is to provide all of the electronics necessary to process the entire signal path in order to provide a turnkey solution for our customers.

On April 28, 2005, we entered into an Agreement and Plan of Merger with Equator Technologies, Inc. ("Equator"). Equator is a leading provider of programmable digital video and audio encoding and decoding solutions with a family of Broadband Signal Processor integrated circuits. Under the terms of the merger agreement, we will purchase all outstanding shares of Equator for approximately $109 million in cash. Additionally, all outstanding options to purchase Equator stock will be converted into options to acquire Pixelworks common stock. The transaction is expected to close in the second quarter of 2005 and is subject to regulatory approval and customary closing conditions. The transaction will be accounted for by the purchase method of accounting. The results of operations of Equator will be included in our financial statements beginning on the date of closing. Accordingly, the discussion of our results of operations below for the quarter ended March 31, 2005 does not include the effects of the Equator transaction.

We sell our products worldwide through a direct sales force and indirectly through distributors and manufacturers' representatives. Manufacturers' representatives support some of our European and Asian sales. We sell to distributors in Japan, Taiwan, China and Europe. Sales to distributors represented 54% and 71% of total revenue for the three months ended March 31, 2005 and 2004, respectively. Effective February 4, 2005, we terminated our distributor relationship with Neoview, one of our Taiwanese distributors. We now sell our products directly to Taiwanese customers previously served by Neoview, as well as through our other Taiwanese distributors. The termination of this relationship led to the decrease in sales to distributors during the three months ended March 31, 2005 compared to the three months ended December 31, 2004.

Historically, significant portions of our revenue have been generated by sales to a relatively small number of end customers and distributors. Sales to our top five end customers represented 36% and 37% of total revenue for the three months ended March 31, 2005 and 2004, respectively. End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and contract manufacturers.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for approximately 99% of total revenue for the three months ended March 31, 2005 and 2004. Our integrators, branded manufacturers and branded suppliers incorporate our products into systems that are sold worldwide. All revenue to date has been denominated in U.S. dollars.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based on our financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The preparation of financial statements in conformity with GAAP requires us to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates, including those related to product returns, warranty obligations, inventories, property and equipment, intangible assets and income taxes. 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, the sales price is fixed and determinable, title and risk of loss have transferred, collection of the resulting receivable is probable and product returns are reasonably estimable. This generally occurs upon shipment of the underlying merchandise.

Sales Returns and Allowances. Our customers do not have a stated right to return product other than under our warranty policy discussed below. As such, customer returns are accepted on a case-by-case basis as customer accommodations only. However, 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. Certain distributors also have price protection provisions in their agreements with us.

We record estimated reductions to gross profit for these sales returns and allowances in our reserve for sales returns and allowances. We update the balance in this reserve at each reporting period based on historical experience. If actual returns and allowances increase, we may be required to recognize additional reductions to gross profit.

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.

We provide for the estimated cost of product warranties in our warranty reserve. We update the balance in this reserve based on historical experience at each reporting period. 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. We evaluate the balance in the allowance based on historical experience and the age of outstanding receivables at each reporting period. 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 ("SFAS") 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.

Goodwill. Goodwill is not amortized. Instead we test goodwill, which represents the excess cost over the fair value of net assets acquired in business combinations, annually for impairment, and more frequently if events and circumstances indicate that it might be impaired. The impairment tests are performed in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* Accordingly, an impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. This determination is made at the reporting unit level. We have assigned all goodwill to a single, enterprise-level reporting unit. The impairment test consists of two steps. First, we determine the fair value of the reporting unit. The fair value is then compared to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation in accordance with SFAS No. 141, *Business Combinations.* The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. We perform our annual impairment test in the first quarter of each year. We did not record any impairment losses against goodwill when we performed the test in the first quarter of 2005 or 2004.

Income Taxes. Deferred income taxes are provided for temporary differences between the amount of assets and liabilities for financial and tax reporting purposes. We establish a valuation allowance in accordance with SFAS No. 109, *Accounting for Income Taxes,* to reduce our deferred tax assets to the amount that is more likely than not to be realized. Should we determine that we will not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset may be charged to income in the period such determination was made.

Tax contingencies are recorded to address potential exposures involving tax positions we have taken that could be challenged by taxing authorities. These potential exposures result from the varying applications of statutes, rules, regulations and interpretations. Our tax contingencies contain assumptions based on past experiences and judgments about potential actions by taxing jurisdictions. The ultimate resolution of these matters may be greater or less than the amount that we have accrued.

Results of Operations

The following table sets forth certain financial data for the periods indicated:

	Three Months Ended March 31,			
	2005		2004	
	Dollars	% of Revenue	Dollars	% of Revenue
Revenue	$ 40,261	100.0%	$ 45,270	100.0%
Cost of revenue	23,343	58.0	21,883	48.3
Gross profit	16,918	42.0	23,387	51.7
Operating expenses:				
Research and development	9,442	23.5	7,704	17.0
Selling, general and administrative	7,068	17.6	5,474	12.1
Stock-based compensation and amortization of assembled workforce	137	0.3	285	0.6
Total operating expenses	16,647	41.3	13,463	29.7
Income from operations	271	0.7	9,924	21.9
Interest income	1,715	4.3	236	0.5
Interest expense	(657)	(1.6)	(1)	—
Amortization of debt issuance costs	(177)	(0.4)	—	—
Interest income, net	881	2.2	235	0.5
Income before income taxes	1,152	2.9	10,159	22.4
Provision for income taxes	316	0.8	3,606	8.0
Net income	$ 836	2.1%	$ 6,553	14.5%

Percentages may not add due to rounding.

Revenue

Revenue for the three months ended March 31, 2005 was 11% lower than revenue for the three months ended March 31, 2004. Changes in units shipped and average selling prices were as follows:

	Percent Change in Units Sold	Percent Change in Average Selling Price
Three months ended March 31, 2005 compared to three months ended March 31, 2004	3%	-14%

Revenue by market as a percentage of gross revenue was as follows:

	Three Months Ended March 31,	
	2005	2004
Advanced televisions	58%	38%
Multimedia projectors	30%	49%
LCD monitors	8%	10%
Other	4%	3%

Advanced Televisions

Total revenue from advanced television sales increased 36% to $23,378 in the first quarter of 2005 from $17,217 in the first quarter of 2004. Units shipped increased 34%, while average selling prices increased 1%. The advanced television market includes products sold into liquid crystal display ("LCD") televisions, digital cathode ray tube ("CRT") televisions, plasma displays, and digital rear projection televisions. Revenue from products sold into the LCD market comprised the majority of our advanced television revenue during the quarters ended March 31, 2005 and March 31, 2004. Our advanced television revenue is generated on sales to customers located in China, Taiwan, Europe, Korea and Japan.

In the second quarter of 2005, we expect that advanced television revenue will increase 5% to 10% over the first quarter of 2005.

Multimedia Projectors

Total revenue from multimedia projector sales decreased 47% to $11,954 in the first quarter of 2005 from $22,392 in the first quarter of 2004. Units shipped decreased 31%, while average selling prices decreased 23%. The decrease in revenue in the multimedia projector market is partially attributable to a general weakening of the overall market and partially to excess channel inventory. Consistent with the first quarter of 2004, the majority of our sales to multimedia projector manufacturers during the three months ended March 31, 2005 were to customers located in Japan. Japanese customers accounted for 87% and 64% of total projector revenue for the three months ended March 31, 2005 and 2004, respectively.

We believe that multimedia projector revenue in the second quarter of 2005 will be within 5% of first quarter 2005 multimedia projector revenue.

LCD Monitors

Total revenue from LCD monitor sales decreased 33% to $3,184 in the first quarter of 2005 from $4,752 in the first quarter of 2004. Units shipped decreased 60% but average selling prices increased 67%. The overall decrease in LCD monitor revenue is primarily attributable to our strategy to stop developing mainstream products for this market. The increase in average selling prices resulted from an increase in the percentage of chips sold into Ultra Extended Graphics Array ("UXGA") monitors, which carry higher average selling prices than chips sold into Super Extended Graphics Array ("SXGA") or Extended Graphics Array ("XGA") monitors. The majority of our monitor revenue is generated on sales to customers located in Taiwan.

In the second quarter of 2005, we expect that our LCD monitor revenue will be within 5% of our first quarter 2005 LCD monitor revenue.

Other

Other revenue includes sales of evaluation kits as well as the impact of changes in our reserve for sales returns and allowances. It also includes sales into small, niche markets that are unrelated to the three primary markets for our products. We do not expect other revenue to be significant in the near future.

Cost of revenue and gross profit

Cost of revenue includes purchased materials, assembly, test, labor and overhead, warranty expense, royalties, amortization of purchased developed technology, provisions for slow moving and obsolete inventory and information technology and facilities allocations.

Gross profit decreased to 42.0% for the three months ended March 31, 2005 from 51.7% for the three months ended March 31, 2004. The decrease is primarily driven by a change in the mix of products sold. The decrease in sales to multimedia projector manufacturers as a percentage of total revenue contributed significantly to the overall decrease in gross profit, as our multimedia projector sales generally have the highest gross profit margins.

We expect our gross profit margin to be flat at approximately 42%, plus or minus 1%, for the second quarter of 2005. This consistency is attributable to the fact that we do not expect any significant changes in the mix of products sold from the first quarter to the second quarter of 2005.

Research and development

Research and development expense includes compensation and related costs for personnel, depreciation and amortization, fees for outside services and expensed equipment and software. Research and development expense, inclusive of stock-based compensation expense, was as follows:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Research and development expense, inclusive of stock-based compensation	$ 9,453	$ 7,784

Research and development expense, inclusive of stock-based compensation expense, increased $1,669, or 21%, from the three months ended March 31, 2004 to the three months ended March 31, 2005 due to the following offsetting factors:

- Depreciation and amortization expense increased $1,259 due to increased licensed technology and software asset purchases.
- Compensation expense increased $502 due to higher headcount in research and development departments during the three months ended March 31, 2005 as compared to the three months ended March 31, 2004. The lower headcount for the three months ended March 31, 2004 was partially attributable to the restructuring that we initiated in the third quarter of 2003 to better position the Company to compete in the advanced television market.
- Facilities and information technology expenses allocated to research and development departments increased $456 from the three months ended March 31, 2004 to the three months ended March 31,

2005. The increase was driven by higher headcount in information technology, higher rent expense, higher depreciation expense and increased communication charges.

- Expensed equipment and software decreased $287.

- We recorded a $163 loss on the disposal of licensed technology during the three months ended March 31, 2004, as we were no longer utilizing the licensed technology and we had no alternate uses for it. There were no such losses recorded during the three months ended March 31, 2005.

We expect our research and development expense to continue to increase in future periods to support our ongoing investment in new product development programs.

Selling, general and administrative

Selling, general and administrative expense includes compensation and related costs for personnel, travel, outside services, sales commissions and overhead incurred in our sales, marketing, customer support, management, legal and other professional and administrative support functions. Selling, general and administrative expense, inclusive of stock-based compensation expense, was as follows:

	Three Months Ended March 31,	
	2005	**2004**
Selling, general and administrative inclusive of stock-based compensation	$ 7,072	$ 5,558

Selling, general and administrative expense, inclusive of stock-based compensation expense, increased $1,514, or 27%, from the three months ended March 31, 2004 to the three months ended March 31, 2005 due to the following factors:

- Compensation expense increased $887 due to an increase in headcount in administrative and sales and marketing personnel required to support future revenue growth and new regulatory requirements.

- The facilities and information technology expenses allocated to selling, general and administrative expense increased $283. The increase was driven by higher headcount in information technology, higher rent expense, higher depreciation expense and increased communication charges.

- Travel and trade show expenses increased $196.

- Depreciation and amortization expense and expensed equipment increased $131.

We expect our selling, general and administrative expenses to increase in future periods. The increases will result from higher sales-related and overhead costs that will be required to support a higher revenue base.

Stock-based compensation and amortization of assembled workforce

Stock-based compensation and amortization of assembled workforce was $137 for the three months ended March 31, 2005, compared to $285 for the comparable period in 2004. Stock-based compensation and amortization of assembled workforce decreased due to our use of the accelerated method of expense recognition for deferred stock-based compensation, under which less expense is recognized in later periods.

Interest income, net

Interest income, net includes interest income earned on cash equivalents and short and long-term marketable securities, interest expense related to our 1.75% convertible subordinated debentures, and amortization of our debt issuance costs which have been capitalized and are included in long-term assets on the balance sheet. The debt issuance costs are being amortized over seven years.

Interest income was $1,715 for the three months ended March 31, 2005 and $236 for the comparable period in 2004. Interest expense was $657 for the three months ended March 31, 2005 and $1 for the comparable period in 2004. Amortization of debt issuance costs was $177 for the three months ended March 31, 2005. Interest income increased due to the investment of the proceeds from the issuance of the debentures. The increase in interest expense is also attributable to the issuance of the 1.75% debentures.

Provision for income taxes

The provision for income taxes for the three months ended March 31, 2005 decreased to $316 from $3,606 for the three months ended March 31, 2004. The decrease in the provision was attributable to our decreased projected income before taxes offset by various credits and other permanent items. The effective tax rate differs from the federal statutory rate primarily due to the utilization of various federal, state and foreign tax credits, the accrual of contingent amounts related to potential permanent establishment exposure and the establishment of a valuation allowance against credits generated in a foreign jurisdiction.

Liquidity and Capital Resources

Cash and cash equivalents and short and long-term marketable securities

As of March 31, 2005 we had cash and cash equivalents of $50,542, short and long-term marketable securities of $219,480 and working capital of $233,442. Cash provided by operations during the three months ended March 31, 2005 was $3,611 compared to $9,810 during the three months ended March 31, 2004. The decrease in cash provided by operations is primarily attributable to lower net income during the three months ended March 31, 2005 as compared to the three months ended March 31, 2004.

Cash provided by investing activities during the three months ended March 31, 2005 was $13,512. This compares to $4,151 provided by investing activities during the three months ended March 31, 2004. Cash provided by investing activities during the three months ended March 31, 2005 resulted from proceeds from maturities of marketable securities, partially offset by purchases of marketable securities, purchases of property and equipment and other assets and payments on accrued balances related to asset purchases. Cash provided by investing activities during the three months ended March 31, 2004 resulted from proceeds from maturities of marketable securities. These proceeds were partially offset by purchases of marketable securities and purchases of property and equipment and other assets.

Cash provided by financing activities was $834 for the three months ended March 31, 2005. This compares to $2,768 provided by financing activities during the three months ended March 31, 2004. Cash provided by financing activities during the first quarter of 2005 and 2004 primarily consists of proceeds from the issuance of common stock from the exercise of stock options and proceeds from the issuance of common stock through the employee stock purchase plan.

On April 28, 2005, we entered into an Agreement and Plan of Merger with Equator Technologies, Inc. ("Equator"). Under the terms of the merger agreement, we will purchase all outstanding shares of Equator for approximately $109 million in cash. Additionally, all outstanding options to purchase Equator stock will be converted into options to purchase Pixelworks common stock. The transaction is expected to close in the second quarter of 2005.

We anticipate that our existing cash and investment balances, along with cash expected to be generated from operations will be adequate to fund our operating and investing needs for the next twelve months and the foreseeable future. From time to time, we may evaluate acquisitions of businesses, products or technologies that compliment our business. Any such transactions, if consummated, may consume a material portion of our working capital or require the issuance of equity securities that may result in dilution to existing shareholders.

Accounts receivable, net

Accounts receivable, net increased to $15,205 at March 31, 2005 from $14,605 at December 31, 2004. The increase is attributable to higher revenue during the three months ended March 31, 2005 compared to the three months ended December 31, 2004. Average days sales outstanding was 34 at March 31, 2005 and December 31, 2004.

Inventories, net

Inventories, net decreased to $13,580 at March 31, 2005 from $18,575 at December 31, 2004. Inventory turnover on an annualized basis increased from approximately four at December 31, 2004 to approximately six at March 31, 2005. At March 31, 2005, this represents approximately nine weeks of inventory. The increase in inventory turnover is primarily attributable to lower inventory levels during the first quarter of 2005.

Contractual Payment Obligations

A summary of our contractual payment obligations as of March 31, 2005 was as follows:

	Payments Due By Period				
Contractual Obligation	**Total**	**2005**	**2006 and 2007**	**2008 and 2009**	**2010 and beyond**
Long-term debt	$ 150,000	$ —	$ —	$ —	$ 150,000
Estimated Q2 2005 non-cancelable purchase commitments to contract manufacturers	22,784	22,784	—	—	—
Operating leases	6,782	3,321	2,798	663	—

The lease payments above are net of sublease rentals of $95 and $40 for the years ending December 31, 2005 and 2006, respectively.

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 Pronouncement

In April 2005, the Securities and Exchange Commission issued release number 33-8568, *Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share Based Payment.* This release delays the date for compliance with Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share Based Payment* ("Statement 123R") from the first interim or annual reporting period beginning after June 15, 2005 to the registrant's first fiscal year beginning on or after June 15, 2005. Statement 123R requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award, and no longer allows companies to apply the intrinsic value based method of accounting for stock compensation described in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees.* While we are still in the process of determining how we will adopt Statement 123R and what the impact on our financial statements will be, we do expect it to have an adverse effect on our consolidated statements of operations and earnings per share.

RISK FACTORS

Investing in our shares of common stock involves a high degree of risk. 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.

RISKS RELATED TO OUR OPERATIONS

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

While we had $836 of net income in the three months ended March 31, 2005 and $21,781 of net income for the year ended December 31, 2004, our accumulated deficit is $58,752 through March 31, 2005. The year ended December 31, 2004 was our first year of annual profitability since inception. In the future we expect our research and development and selling, general and administrative expenses to increase. Given expected increases in operating expenses, we must increase revenues and gross profit to remain profitable. We cannot be certain that we will achieve profitability in the future or, if we do, that we can sustain or increase profitability on a quarterly or annual basis. This may in turn cause the price of our common stock to decline. In addition, if we are not profitable in the future we may be unable to continue our operations.

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

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

- demand for multimedia projectors, advanced televisions and LCD monitors;

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

These factors are difficult or impossible to forecast, and these or other factors could seriously harm our business. We anticipate the rate of new orders may vary significantly from quarter to quarter.

Our operating expenses and inventory levels are based on our expectations of future revenues and our operating expenses are relatively fixed in the short term. Consequently, if anticipated sales and shipments in any quarter do not occur when expected, operating expenses and inventory levels could be disproportionately high, and our operating results for that quarter and, potentially, future quarters may be negatively impacted. Any shortfall in our revenues would have a direct impact on our business. In addition, fluctuations in our quarterly results could adversely affect the price of our common stock in a manner unrelated to our long-term operating performance. Because our operating results are volatile and difficult to predict, you should not rely on the results of one quarter as an indication of our future performance. It is possible that in some future quarter our operating results will fall below the expectations of securities analysts and investors. In this event, the price of our common stock may decline significantly.

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

Average selling prices for our products decline over relatively short time periods while many of our product costs are fixed. When our average selling prices decline, our gross profits decline 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 margins decline. We have experienced these results and expect that we will continue to experience them in the future, although we cannot predict when they may occur or how severe they will be.

Our highly integrated products and high-speed mixed signal products are difficult to manufacture without defects and the existence of defects could result in an increase in our costs and delays in the availability of our products.

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.

The ability to manufacture products of acceptable quality depends on both product design and manufacturing process technology. Since defective products can be caused by either design or manufacturing difficulties, 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. Failure to achieve defect-free products due to their increasing complexity may result in an increase in our cost and delays in the availability of our products. For example, we have experienced field failures of our ICs in certain customer system applications that required us to institute additional IC level testing. As a result of these field failures we incurred costs due to customers returning potentially affected products. Additionally, customers have experienced delays in receiving product shipments from us that resulted in the loss of revenue and profits. Shipment of defective products may also harm our reputation with customers.

If we do not achieve additional design wins in the future, our ability to grow would be seriously limited.

Our future success will depend 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, 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 harm our business, financial condition and results of operations.

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 revenues from that developer if that developer's products are not commercially successful or if that developer chooses to qualify a second source for the products that we promote.

Because of the complex nature of our semiconductor designs and of the associated manufacturing process 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 revenues.

The development of our semiconductors, some of which incorporate mixed analog and digital signal processing, is highly complex. These complexities require that we employ advanced designs and manufacturing processes that are unproven. We have experienced increased development time and delays in introducing new products that resulted in significantly less revenue than originally expected for those products. We will not always succeed in developing new products or product enhancements nor will we always do so in a timely manner. Acquisitions have significantly added to the complexity of our product development efforts. We must now coordinate very complex product development programs between multiple geographically dispersed locations.

Many of our designs involve the development of new high-speed analog circuits that are difficult to simulate and that require physical prototypes not required by the primarily digital circuits we currently design. The result could be longer and less predictable development cycles.

Successful development and timely introduction of new or enhanced products depends on a number of other factors, including:

- accurate prediction of customer requirements and evolving industry standards, including digital interface and content piracy protection standards;
- development of advanced display technologies and capabilities;
- timely completion and introduction of new product designs;
- use of advanced foundry processes and achievement of high manufacturing yields; and
- market acceptance of the new products.

If we are not able to successfully develop and introduce our products in a timely manner, our business and results of operations will be adversely affected.

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

Our products incorporate software and software development tools. The integration of software 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. Some customers and potential customers may choose not to use our products because of the additional requirements of implementing our software, preferring to use a product that works with their existing software. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

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

We are and will continue to be dependent on a limited number of large distributors and customers for a substantial portion of our revenue. Sales to distributors represented 54% of our total revenue for the three months ended March 31, 2005, and 69%, 69% and 68% of total revenue for the years ending December 31, 2004, 2003 and 2002, respectively. During the three months ended March 31, 2005, sales to Tokyo Electron Device Limited, or TED, our Japanese distributor, represented 24% of our total revenue. Sales to TED represented 31%, 39% and 45%, respectively, of our total revenue for the years ended December 31, 2004, 2003 and 2002. Sales to our top five end customers accounted for approximately 36% of our total revenue for the three months ended March 31, 2005, and 33%, 35% and 41% of our total revenue for the years ended December 31, 2004, 2003 and 2002, respectively. As a result of this distributor and end customer concentration, any one of the following factors could significantly impact our revenues:

- a significant reduction, delay or cancellation of orders from one or more of our key distributors, branded manufacturers or integrators; or

- a decision by one or more significant customers to select products manufactured by a competitor, or its own internally developed semiconductor, for inclusion in future product generations.

The display manufacturing market is highly concentrated among relatively few large manufacturers. We expect our operating results to continue to depend on revenues from a relatively small number of customers.

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.

At March 31, 2005 we had two customers that represented more than 10% of our accounts receivable. TED represented 13% and 26% of total accounts receivable at March 31, 2005 and December 31, 2004, respectively. A second customer accounted for 18% and 11% of total accounts receivable at March 31, 2005 and December 31, 2004, respectively. The failure to pay these balances by these or any other customer representing 10% or more of our total accounts receivable in the future would result in an expense that would increase our operating expenses and would reduce our cash flows.

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

Sales outside the U.S. accounted for approximately 99% of total revenue for the three months ended March 31, 2005 and 2004. 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 outside of the U.S., thereby exposing us indirectly to further international risks. In addition, 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 of our products and components due to varying time zones, languages and business customs;

- foreign currency exchange fluctuations such as the devaluation in the currencies of Japan, Taiwan and Korea that could result in an increased cost of procuring our semiconductors;

- potentially adverse tax consequences, such as license fee revenue taxes imposed in Japan;

- difficulties regarding timing and availability of export and import licenses, which have limited our ability to freely move demonstration equipment and samples in and out of Asia;

- political and economic instability, particularly in the People's Republic of China ("PRC"), Taiwan and Korea;

- reduced or limited protection of our intellectual property, significant amounts of which are contained 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 for foreign receivables;

- difficulties in maintaining sales representatives outside of the U.S. that are knowledgeable about the display processor industry and our display processor products;
- changes in the regulatory environment in the PRC, Japan, Korea and Taiwan that may significantly impact purchases of our products by our customers;
- outbreaks of SARS or other pandemics in the PRC or other parts of Asia; and
- difficulties in collecting accounts receivable.

Our growing presence and investment within the Peoples 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 and a large number of our customers are geographically concentrated in the PRC. In addition, approximately 29 percent of our employees are located in this area and we made an investment of $10,000 in Semiconductor Manufacturing International Corporation (SMIC) located in Shanghai, China in the third quarter of 2003. Disruptions from natural disasters, health epidemics (including new outbreaks of SARS or bird flu) and political, social and economic instability may affect the region, and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to state plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot assure, however, 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.

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

Selling through distributors reduces our ability to forecast sales 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. This arrangement requires us to manage a more complex supply chain and monitor the financial condition and creditworthiness of our distributors and customers. Our failure to manage one or more of these challenges could result in excess inventory or shortages that could seriously impact our operating revenue or limit the ability of companies using our semiconductors to deliver their products.

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 revenues.

We do not own or operate a semiconductor fabrication facility and we do not have the resources to manufacture our products internally. We rely on third-party foundries for wafer fabrication and other contract manufacturers for assembly and testing of our products. Our requirements represent only a small portion of the total production capacity of our contract manufacturers. Our third-party manufacturers have in the past re-allocated capacity to other customers even during periods of high demand for our products. We expect that this may occur again in the future. 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, in any specific quantity or at any specific price, except as may be provided in a particular purchase order. From time to time our third-party manufacturers increase prices charged to manufacture our products with little notice. This requires us to either increase the price we charge for our products or suffer a decrease in our gross margins. We try not to maintain substantial inventories of products, but need to order products long before we have firm purchase orders for those products which could result in excess inventory or inventory shortages.

If we are unable to obtain our products from manufacturers on schedule, our ability to satisfy customer demand will be harmed, and revenue from the sale of products may be lost or delayed. If orders for our products are cancelled, expected revenues would not be realized. In addition, if the price charged by our third-party manufacturers increases we will be required to increase our prices, which could harm our competitiveness.

The concentration of our manufactures 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 and Taiwan. The risk of earthquakes in the Pacific Rim region is significant due to the proximity of major earthquake fault lines in the area. A current manufacturer's facilities were affected by a significant earthquake in Taiwan in September 1999. As a consequence of this earthquake, the manufacturer suffered power outages and disruption that impaired its 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 likely would result in the disruption of our manufacturers' and customers' operations. Any disruption resulting from extraordinary events could cause significant delays in shipments of our productss 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, if at all.

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

We are building many 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 would result in higher product costs, which could make our products uncompetitive with products offered by our competitors if we chose to increase our prices, or could result in low gross profit margins if we did not increase our prices.

We are dependent on our foundries to implement complex semiconductor technologies, which could adversely affect our operations if those technologies are not available, 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 and adversely affected if advanced manufacturing processes are unavailable to us, substantially delayed or inefficiently implemented.

Manufacturers of our semiconductor products periodically discontinue 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. 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 on the newer process. In the event that a manufacturing process is discontinued, our products could become unavailable from our current suppliers. Additionally, migrating to a new, more advanced process requires significant expenditures for research and development. A significant portion of our products use embedded DRAM technology and the required manufacturing process for this technology is anticipated to be available for at least the next two to three years. We also utilize a 0.18um standard logic process, which we expect will be readily available for the next five to seven years. We have commitments from our suppliers to notify us in the event of a discontinuance of a manufacturing process in order to assist us with product transitions.

If we have to qualify a new contract manufacturer or foundry for any of our products, we may experience delays that result in lost revenues and damaged customer relationships.

None of our products are fabricated by more than one supplier. Additionally, our products require manufacturing with state-of-the-art fabrication equipment and techniques. Because the lead-time needed to establish a relationship with a new contract manufacturer is at least six 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 alternative source of supply for any specific product. This could cause significant delays in shipping products, which may result in lost revenues and damaged customer relationships.

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.

Our future success depends upon the continued services of our executive officers, key hardware and software engineers, and sales, marketing and support personnel, many of whom would be difficult to replace. The loss of one or more of these employees, particularly Allen Alley, our President and Chief Executive Officer, could seriously harm our business. In addition, 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. We believe our success depends, in large part, upon our ability to identify, attract and retain qualified hardware and software engineers, and 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. We have experienced, and may continue to experience, difficulty in hiring and retaining employees with appropriate qualifications. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenues and business could be seriously harmed.

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

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

Development projects may cause us to incur substantial operating expenses without the guarantee of any associated revenue or far in advance of revenue.

We have development projects that consume large amounts of engineering resources far in advance of product revenue. Our work under these projects is technically challenging and places considerable demands on our limited resources, particularly on our most senior engineering talent, and may not result in revenue for twelve to eighteen months, if at all. In addition, allocating significant resources to these projects may detract from or delay the completion of other important development projects. Any of these development projects could be canceled at any time without notice. These factors could have a material and adverse effect on our long-term business and results of operations.

Because of our long product development process and sales cycle, we may incur substantial expenses before we earn associated revenues and may not ultimately sell as many units of our products as we forecasted.

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 revenues. 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 equipment can take up to six months or more. It can take an additional six months before a customer commences volume shipments of systems that incorporate our products. Even when we achieve a design win, the customer may never ship systems incorporating our products. We cannot assure you that the time required for the testing, evaluation and design of our products by our customers would not exceed six months. Because of this lengthy development cycle, we will experience delays between the time we incur expenditures for research and development, sales and marketing, inventory levels and the time we generate revenues, if any, from these expenditures. Additionally, if actual sales volumes for a particular product are substantially less than originally forecasted, we may experience large write-offs of capitalized license fees, product masks and prepaid royalties that would negatively affect our operating results.

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 liquid crystal display panels and other display components, analog-to-digital converters, digital receivers and video decoders. During 2000, some of our customers experienced delays in the availability of key components from other suppliers, which, in turn, caused a delay in demand for the products that we supplied to our customers.

Shortages of materials used in the manufacturing of our products may increase our costs or limit our revenues 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 negatively impact our earnings.

Our products could become obsolete if necessary licenses of third-party technology are not available to us or are only available on terms that are not commercially viable.

We license technology from third parties that is incorporated into our products or product enhancements. Future products or product enhancements may require additional third-party licenses that may not be available to us or available on terms that are commercially reasonable. If we are unable to obtain any third-party license required to develop new products and product enhancements, we may have to obtain substitute technology of lower quality or performance standards or at greater cost, either of which could seriously harm the competitiveness of our products.

We may not be able to respond to the rapid technological changes in the markets in which we 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 the emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Examples of changing industry standards include the introduction of high-definition television, or HDTV, new digital receivers and displays with resolutions that have required us to accelerate development of new products to meet these new standards.

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.

Our existing products incorporate complex software tools designed to help customers bring products 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, software development is a volatile market and new software languages are introduced to the market that 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.

Our integrated circuits and software could contain defects, which could reduce sales of those products or result in claims against us.

Despite testing by both our customers and us, errors or performance problems may be found in existing or new semiconductors and software. This could result in a delay in the recognition or loss of revenues, loss of market share or failure to achieve market acceptance. These defects may cause us to incur significant warranty, support and repair costs. They could also divert the attention of our engineering personnel from our product development efforts and harm our relationships with our customers. The occurrence of these problems could result in the delay or loss of market acceptance of our semiconductors and would likely harm our business. Defects, integration issues or other performance problems in our semiconductors and software could result in financial or other damages to our customers or could damage market acceptance of our products. Our customers could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

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

We may become subject to claims involving patents or other intellectual property rights. For example, in early 2000, we were notified by InFocus Corporation ("InFocus") that we were infringing on patents held by InFocus. In February 2000, we entered into a license agreement with InFocus granting us the right to use the technology covered by those InFocus patents. As a result, we recorded a one-time charge of $4,078 for patent settlement expense in the first quarter of 2000. Intellectual property claims could subject us to significant liability for damages and invalidate our proprietary rights. In addition, intellectual property 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 future intellectual property 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 intellectual property;
- attempt to obtain a license to the relevant intellectual property, which license may not be available on reasonable terms or at all;
- attempt to redesign those products that contain the allegedly infringing intellectual property; and
- 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 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 could adversely affect our ability to increase our earnings.

Our limited ability to protect our intellectual property and proprietary rights could harm our competitive position by allowing our competitors to access our proprietary technology and to introduce similar display processor 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 rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to protect our proprietary technologies. We hold 15 U.S. patents and have 49 patent applications pending with the U.S. Patent and Trademark Office for protection of our significant technologies. We cannot assure you that the degree of protection offered by patents 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, if issued, any claims allowed will be sufficiently broad to protect our technology. In addition, it is possible that existing or future patents may be challenged, invalidated or circumvented. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. In addition, we provide the computer programming code for our software to selected customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software.

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

To date, we have acquired Panstera, Inc. in January 2001, nDSP in January 2002 and Jaldi Semiconductor in September 2002. In March 2003, we announced the execution of a definitive merger agreement with Genesis Microchip, Inc.; however, the merger was terminated in August of 2003, and we incurred $8,949 of expenses related to the transaction. In the third quarter of 2003, we made an investment of $10,000 in SMIC. On April 28, 2005, we entered into an Agreement and Plan of Merger with Equator Technologies, Inc. Under terms of the merger agreement, we will purchase all outstanding shares of Equator for approximately $109 million in cash. Additionally, all outstanding options to purchase Equator stock will be converted into options to purchase Pixelworks common stock. The transaction is expected to close in the second quarter of 2005. We intend to continue to consider investments in or acquisitions of complementary businesses, products or technologies.

The acquisitions of Panstera, nDSP and Jaldi contained a very high level of risk primarily because the investments were made based on in-process technological development that may not have been completed, or if completed, may not have become commercially viable.

These and any future acquisitions and investments could result in:

- issuance of stock that dilutes current shareholders' percentage ownership;
- incurrence of debt;
- assumption of liabilities;
- amortization expenses related to other intangible assets;
- impairment of goodwill; or
- large and immediate write-offs.

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

- problems combining the purchased 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.

We may not be able to successfully integrate businesses, products, technologies or personnel 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 companies with weak internal controls, it will take time to get the acquired company up to the same level of operating effectiveness as Pixelworks. Our inability to address these risks could negatively affect our operating results.

Goodwill represents a significant portion of our total assets.

As of March 31, 2005, goodwill amounted to $80,836 or approximately 19% of our total assets. We are required to review goodwill for possible impairment on an annual basis or when events and circumstances arise which indicate a possible impairment. The review of goodwill for impairment may result in large write-offs of goodwill, which could have a material adverse effect on our results of operations.

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

In the second quarter of 2004, we issued $150,000 of 1.75% convertible debentures due 2024 in a private placement pursuant to Rule 144A and Regulation S under the Securities Act of 1933. As a result of this indebtedness, our principal obligations increased substantially. These debt obligations could materially and adversely affect our ability to obtain debt 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 could make us more vulnerable to industry downturns and competitive pressures. 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, many of which are beyond our control.

Failure to manage our expansion effectively could adversely affect our ability to increase our business and our results of operations.

Our ability to successfully market and sell our products in a rapidly evolving market requires effective planning and management processes. We continue to increase the scope of our operations domestically and internationally and have increased our headcount from 241 employees at the end of 2003 to 377 at March 31, 2005. Upon the closing of our acquisition of Equator Technologies, Inc. we will further expand the scope of our operations and our headcount. Our past growth, and our expected future growth, places a significant strain on our management systems and resources including our financial and managerial controls, reporting systems and procedures. To manage our growth effectively, we must implement and improve 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. Moreover, we could spend substantial amounts of time and money in connection with our rapid growth and may have unexpected costs. 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. While we have not, to date, suffered any significant adverse consequences due to our growth, if we do not continue to manage growth effectively our operating expenses could increase more rapidly than our revenue causing decreased profitability.

Risks Related to Our Industry

Failure of consumer demand for advanced displays and other digital display technologies to increase would impede our growth and adversely affect our business.

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

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 these products, or consumers will 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.

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

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

We compete with specialized and diversified electronics and semiconductor companies that offer display processors or scaling components. Some of these include ATI, Genesis Microchip, I-Chips, ITE, Macronix, Mediatek, Media Reality Technologies, Micronas, MStar Semiconductor, Inc., Oplus, Realtek, Silicon Image, Silicon Optix, STMicroelectronics, Techwell, Topro, Trident, Trumpion, Weltrend, Zoran and other companies. Potential competitors may include diversified semiconductor manufacturers and the semiconductor divisions or affiliates of some of our customers, including Intel, Koninlijke Philips Electronics, LG Electronics, Matsushita Electric Industrial, Mitsubishi, National Semiconductor, NEC, nVidia, Samsung Electronics, Sanyo Electric Company, Sharp Corporation, Sony Corporation, Texas Instruments and Toshiba Corporation. 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. Some of our competitors may operate their own fabrication facilities. These competitors may be able to react more quickly and devote more resources to efforts that compete directly with our own. In the future, our current or potential customers may also develop their own proprietary display processors and become our competitors. Our competitors may develop advanced technologies enabling them to offer more cost-effective and higher quality semiconductors to our customers than those offered by us. Increased competition could harm our business, financial condition and results of operations by, for example, increasing pressure on our profit margin or causing us to lose sales opportunities. We cannot assure you that we can compete successfully against current or potential competitors.

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

In the past, the semiconductor industry has been characterized by significant downturns and wide fluctuations in supply and demand. Also, during this time, the industry has experienced significant fluctuations in anticipation of changes in general economic conditions, including economic conditions in Asia and North America. The cyclical nature of the semiconductor industry has led to significant variances in product demand and production capacity. It has also accelerated erosion of average selling prices per unit. We may experience periodic fluctuations in our future financial results because of changes in industry-wide conditions.

Other Risks

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 the shareholders consider the merger or acquisition 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 create and issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us or change our control, commonly referred to as “blank check” preferred stock;
- members of our board of directors can only be removed for cause;
- 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 principal shareholders have significant voting power and may take actions that may make it more difficult to sell our shares at a premium to take over candidates.

Our executive officers, directors and other principal shareholders, in the aggregate, beneficially own 20,282,490 shares or approximately 43% of our outstanding common stock and exchangeable shares as of

April 30, 2005. These shareholders currently have, and will continue to have, significant influence with respect to the election of our directors and approval or disapproval of our significant corporate actions. This influence over our affairs might be adverse to the interest of our other shareholders. In addition, the voting power of these shareholders could have the effect of delaying or preventing a change in control of our business or otherwise discouraging a potential acquirer from attempting to obtain control of us, which could prevent our other shareholders from realizing a premium over the market price for their common stock.

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

Investors may not be able to sell shares of our common stock at or above the price they paid due to a number of factors, including:

- 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.

In particular, the stock prices of technology companies similar to us have been highly volatile. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. Market fluctuations as well as general economic, political and market 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.

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

We believe our current cash and marketable security balances will be sufficient to meet our capital requirements for the next 12 months. However, we may need, or could elect to seek, additional funding prior to that time. To the extent that currently available funds are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. Additional funds may not be available on terms favorable to us or our shareholders. Further, if we issue equity securities, our shareholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of our common stock. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements.

We may be unable to meet changing laws, regulations and standards relating to corporate governance and public disclosure.

We are spending an increasing amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management's annual review and evaluation of our internal control systems, and attestations of the effectiveness of these systems by our independent registered public accounting firm. The process of documenting and testing our controls has required that we hire additional personnel and outside advisory services and has resulted in additional accounting and legal expenses. 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 we believe that we have remediated the material weakness identified, our disclosure of this material weakness may impact investor perception of our company and may affect our stock price. In addition, there are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can provide only reasonable assurance of achieving their control objectives.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our primary market risk exposure is the impact of interest rate fluctuations on interest income earned on our investment portfolio. We mitigate risks associated with such fluctuations, as well as the risk of loss of principal, by investing in high-credit quality securities and limiting concentrations of issuers and maturity dates. Derivative financial instruments are not part of our investment portfolio.

As of March 31, 2005, we had convertible subordinated debentures of $150,000 outstanding with a fixed interest rate of 1.75%. Interest rate changes affect the fair value of the debentures, but do not affect our earnings or cash flow.

All of our sales are denominated in U.S. dollars and as a result, we have relatively little exposure to foreign currency exchange risk with respect to our sales. We have employees located in offices in Canada, Japan, Taiwan and the People's Republic of China and as such, a portion of our operating expenses are denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. While we cannot reasonably estimate the effect that an immediate 10% change in foreign currency exchange rates would have on our operating results or cash flows, we believe that the effect would not be material. We do not currently hedge against foreign currency rate fluctuations.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures*.

Our management, with the participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), carried out an evaluation of the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report pursuant to Securities Exchange Act Rule 13a-15(e) and 15d-15(e). Based upon this evaluation, our CEO and CFO concluded that our controls and procedures are effective in timely alerting them to material information regarding the Company (including its consolidated subsidiaries) required to be included in our periodic SEC filings.

(b) *Changes in Internal Controls*.

In response to the material weakness that we identified during our December 31, 2004 assessment of the effectiveness of our system of internal control over financial reporting, during the quarter ended March 31, 2005, we strengthened our internal controls over the review of our income tax accounting procedures by significantly increasing the scope of our outside tax expert's review engagement, and by formalizing policies and procedures to ensure appropriate communication and follow up of comments noted by expert reviewers.

There have been no other significant changes in our internal controls over financial reporting, and no other significant deficiencies or material weaknesses have been identified which required corrective action.

Item 6. Exhibits

31.1 Certification of Chief Executive Officer.

31.2 Certification of Chief Financial Officer.

32.1 Certification of Chief Executive Officer.

32.2 Certification of Chief Financial Officer.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PIXELWORKS, INC.

Dated: May 9, 2005

/s/ Jeffrey B. Bouchard

Jeffrey B. Bouchard
Vice President, Finance and
Chief Financial Officer

Exhibit 31.1

CERTIFICATION

I, Allen H. Alley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pixelworks, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 9, 2005

/s/ Allen H. Alley
Allen H. Alley
Chairman of the Board,
President and
Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Jeffrey B. Bouchard, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pixelworks, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 9, 2005

/s/ Jeffrey B. Bouchard
Jeffrey B. Bouchard
V*ice President, Finance and*
Chief Financial Office

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Pixelworks, Inc. (the "Company") on Form 10-Q for the three months ended March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Allen H. Alley, Chairman of the Board, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Allen H. Alley
Allen H. Alley
Chairman of the Board,
President and
Chief Executive Officer

Date: May 9, 2005

Exhibit 32.2

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Pixelworks, Inc. (the “Company”) on Form 10-Q for the three months ended March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Jeffrey B. Bouchard, Vice President, Finance and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Jeffrey B. Bouchard
Jeffrey B. Bouchard
Vice President, Finance and
Chief Financial Officer

Date: May 9, 2005