# 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 September 30, 2001**

**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™

(Exact name of registrant as specified in its charter)

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

**7700 SW Mohawk**
**Tualatin, Oregon 97062**
**(503) 612-6700**
(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 ☐

Number of shares of Common Stock outstanding as of October 31, 2001: 41,368,777

**PIXELWORKS, INC.**

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## PART 1 - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

**PIXELWORKS, INC.**
**CONDENSED BALANCE SHEETS**

**(in thousands)**

| ASSETS | September 30, 2001 (Unaudited) | December 31, 2000 |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 61,941 | $ 49,681 |
| Short-term marketable securities | 33,024 | 54,051 |
| Accounts receivable, net | 8,518 | 6,608 |
| Inventories, net | 3,693 | 3,280 |
| Prepaid expenses and other current assets | 3,259 | 592 |
| Total current assets | 110,435 | 114,212 |
| Property and equipment, net | 5,289 | 3,660 |
| Long-term marketable securities | 2,325 | - |
| Goodwill and assembled workforce, net | 74,352 | - |
| Other assets, net | 10,499 | 2,422 |
| Total assets | $ 202,900 | $ 120,294 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $ 6,360 | $ 10,724 |
| Accrued liabilities | 4,025 | 3,117 |
| Total current liabilities | 10,385 | 13,841 |
| Shareholders' equity: | | |
| Common stock | 259,374 | 126,260 |
| Deferred stock compensation | (8,773) | (2,206) |
| Note receivable for common stock | (84) | (172) |
| Accumulated deficit | (58,002) | (17,429) |
| Total shareholders' equity | 192,515 | 106,453 |
| Total liabilities and shareholders' equity | $ 202,900 | $ 120,294 |

The accompanying notes are an integral part of these condensed financial statements.

**PIXELWORKS, INC.**

**CONDENSED STATEMENTS OF OPERATIONS**

**(Unaudited)**
**(in thousands, except share and per share data)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2001 | 2000 | 2001 | 2000 |
| Revenue | $ 24,074 | $ 15,285 | $ 68,149 | $ 34,472 |
| Cost of revenue(1) | 12,607 | 8,941 | 36,667 | 20,847 |
| Gross profit | 11,467 | 6,344 | 31,482 | 13,625 |
| Operating expenses: | | | | |
| Research and development(2) | 4,379 | 3,112 | 12,913 | 7,146 |
| Selling, general and administrative(3) | 4,226 | 2,497 | 11,833 | 6,402 |
| Amortization of goodwill and assembled workforce | 4,359 | - | 11,623 | - |
| Patent settlement expense | - | - | - | 4,078 |
| In-process research and development expense | - | - | 32,400 | - |
| Amortization of deferred stock compensation | 2,539 | 600 | 6,873 | 1,627 |
| Total operating expenses | 15,503 | 6,209 | 75,642 | 19,253 |
| Income (loss) from operations | (4,036) | 135 | (44,160) | (5,628) |
| Interest income | 997 | 1,677 | 3,587 | 2,898 |
| Interest expense | - | - | - | (38) |
| Other expense, net | - | (34) | - | (24) |
| Interest income and other expense, net | 997 | 1,643 | 3,587 | 2,836 |
| Income (loss) before income taxes | (3,039) | 1,778 | (40,573) | (2,792) |
| Income tax provision | - | - | - | - |
| Net income (loss) | (3,039) | 1,778 | (40,573) | (2,792) |
| Preferred stock beneficial conversion feature | - | - | - | 9,995 |
| Accretion of preferred stock redemption preference | - | - | - | 2,100 |
| Net income (loss) attributable to common shareholders | $ (3,039) | $ 1,778 | $ (40,573) | $ (14,887) |
| Basic net income (loss) per share | $ (0.07) | $ 0.05 | $ (1.00) | $ (0.68) |
| Diluted net income (loss) per share | $ (0.07) | $ 0.05 | $ (1.00) | $ (0.68) |
| Weighted average shares – basic | 41,128,835 | 36,309,018 | 40,453,591 | 21,879,089 |
| Weighted average shares – diluted | 41,128,835 | 39,386,761 | 40,453,591 | 21,879,089 |
| Amount excludes amortization of deferred stock compensation of: | | | | |
| (1) Cost of revenue | $ 10 | $ 22 | $ 30 | $ 47 |
| (2) Research and development | 1,909 | 217 | 5,128 | 609 |
| (3) Selling, general and administrative | 620 | 361 | 1,715 | 971 |

The accompanying notes are an integral part of these condensed financial statements.

## PIXELWORKS, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

**(Unaudited)**
**(in thousands)**

| | Nine Months Ended September 30, 2001 | Nine Months Ended September 30, 2000 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $ (40,573) | $ (2,792) |
| Adjustments to reconcile net loss to net cash provided by operating activites: | | |
| Depreciation and amortization | 3,225 | 1,663 |
| Write-off of property and equipment and other assets | - | 435 |
| Provision for doubtful accounts | 26 | 57 |
| Amortization of goodwill and assembled workforce | 11,623 | - |
| Amortization of deferred stock compensation | 6,873 | 1,627 |
| Patent settlement expense | - | 4,078 |
| In-process research and development expense | 32,400 | - |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,936) | (3,486) |
| Inventories | (413) | 46 |
| Prepaid expenses and other current assets | (2,153) | (876) |
| Accounts payable | (4,704) | 4,187 |
| Accrued liabilities | 907 | 877 |
| Net cash provided by operating activities | 5,275 | 5,816 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (4,008) | (2,715) |
| Other assets | (1,822) | (1,496) |
| Investment in Jaldi | (7,500) | - |
| Purchases of marketable securities | (47,359) | (20,469) |
| Maturities of marketable securities | 66,062 | - |
| Net cash provided by (used in) investing activities | 5,373 | (24,680) |
| Cash flows from financing activities: | | |
| Net decrease in lines of credit | - | (669) |
| Payments on long-term debt | - | (1,083) |
| Proceeds from issuances of preferred stock | - | 26,528 |
| Proceeds from initial public offering, net of costs | - | 60,528 |
| Issuances of common stock | 1,612 | 386 |
| Net cash provided by financing activities | 1,612 | 85,690 |
| Increase in cash and cash equivalents | 12,260 | 66,826 |
| Cash and cash equivalents at beginning of period | 49,681 | 12,199 |
| Cash and cash equivalents at end of period | $ 61,941 | $ 79,025 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the respective periods for: | | |
| Interest | $ - | $ - |
| Taxes | $ 118 | $ - |

The accompanying notes are an integral part of these condensed financial statements.

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

**Note 1: Basis of Presentation**

The financial information included herein for the three and nine months ended September 30, 2001 and 2000 is unaudited; however, such information reflects all adjustments consisting only of normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the three and nine months ended September 30, 2001 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2001.

These financial statements have been prepared by Pixelworks, Inc. (the "Company") 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 accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such regulations, although the Company believes the disclosures provided are adequate to prevent the information presented from being misleading.

This report on Form 10-Q for the quarter ended September 30, 2001, should be read in conjunction with the Company's Annual Report on Form 10-K filed on April 2, 2001. Portions of the accompanying financial statements are derived from the audited year-end financial statements of the Company dated December 31, 2000.

**Segments** – Statement of Financial Accounting Standards ("SFAS") No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for disclosure about operating segments in annual financial statements and selected information in interim financial reports. Based on definitions contained within SFAS 131, the Company has determined that it operates within one segment. Substantially all of the assets of the Company are located in the United States. Revenues are attributed to countries based on the domicile of the customer. Revenue by geographic region was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2001** | **2000** | **2001** | **2000** |
| Japan | $ 12,693 | $ 8,989 | $ 35,412 | $ 20,047 |
| Taiwan | 3,246 | 2,555 | 9,059 | 6,052 |
| Korea | 3,287 | 1,905 | 10,932 | 4,702 |
| Europe | 1,484 | 1,126 | 5,336 | 2,169 |
| United States | 3,233 | 573 | 6,997 | 1,125 |
| Other | 131 | 137 | 413 | 377 |
| Total revenue | $ 24,074 | $ 15,285 | $ 68,149 | $ 34,472 |

**Note 2: Earnings per share**

Basic earnings per share ("EPS") is computed on the basis of weighted average number of common shares outstanding. Diluted EPS is computed on the basis of weighted average common shares outstanding and potentially dilutive common equivalent shares outstanding during the period. Potentially dilutive common equivalent shares consist of the effect of outstanding stock options using the "treasury stock" method, shares of convertible preferred stock on an as converted basis, and shares of restricted stock, if the potential common shares were not anti-dilutive.

The following weighted-average potential common shares have been excluded from the computation of diluted loss per share for the periods presented because the effect would have been anti-dilutive:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2001 | 2000 | 2001 | 2000 |
| Potential common stock equivalent shares related to stock options | 2,942,663 | 19,442 | 2,953,142 | 2,836,132 |
| Shares of restricted stock subject to repurchase | 110,749 | - | 134,097 | 922,791 |
| Shares of convertible preferred stock on an as converted basis | - | - | - | 7,463,367 |

Potential common stock equivalents shares related to stock options includes 692,096, 19,442, 599,593, and 18,384 weighted shares for which the options' exercise price was greater than the average market price for the three and nine months ended September 30, 2001 and 2000, respectively.

**Note 3: Inventories**

Inventories are stated at the lower of cost (on a first-in, first-out basis) or market (net realizable value) and consist of the following:

| | September 30, 2001 | December 31, 2000 |
|---|---|---|
| Finished goods | $ 3,481 | $ 2,763 |
| Work-in-process | 212 | 517 |
| | $ 3,693 | $ 3,280 |

**Note 4: Acquisitions**

On January 30, 2001, the Company acquired all of the outstanding shares of Panstera, Inc. in exchange for approximately 4,500,000 shares of Pixelworks stock valued as follows:

| | Shares | Fair Value |
|---|---|---|
| Shares | 3,722,953 | $ 108,974 |
| Stock options | 777,047 | 22,616 |
| | 4,500,000 | 131,590 |
| Acquisition costs | | 335 |
| | | $ 131,925 |

The transaction was accounted for by the purchase method of accounting, and accordingly, the results of operations of Panstera, Inc. are included in the Company's financial statements beginning on the date of acquisition.

The allocation of purchase price was as follows:

| | |
|---|---|
| Net tangible assets | $ 110 |
| Intangible assets: | |
| Aquired in-process research and development | 32,400 |
| Deferred compensation on unvested stock awards assumed | 13,440 |
| Assembled workforce | 1,800 |
| Goodwill | 84,175 |
| Total purchase price | $ 131,925 |

In connection with this acquisition, the Company recorded a one-time charge of $32.4 million for the write-off of in-process research and development ("IPR&D"). The value assigned to IPR&D related to research projects for which technological feasibility had not been established. The value was determined by estimating the net cash flows from the sale of products from 2001 through 2005 resulting from the completion of such projects, and discounting the net cash flows back to their present value using a risk adjusted rate of 35%. The estimated net cash flows from these products were based on management's estimates of related revenues, cost of goods sold, R&D costs, selling, general and administrative costs and income taxes. The Company then estimated the stage of completion of the products at the date of the acquisition based on R&D costs that had been expended as of the date of acquisition as compared to total R&D costs at completion. The percentages derived from this calculation were then applied to the net present value of future cash flows to determine the in-process charge. The nature of the efforts to develop the in-process technology into commercially viable products principally related to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its design specification, including function, features and technical performance requirements.

Panstera had four main product groups under development at the acquisition date, each contributing from 11% to 41% to the total IPR&D value. The projects included the development of digital and analog receivers as well as digital processor ICs. The projects ranged from 50% to 85% complete. All projects had expected completion dates within one year and an estimated aggregate cost to complete of $3.2 million.

The following table reflects the unaudited combined results of Pixelworks, Inc. and Panstera, Inc. as if the merger had taken place at the beginning of the three months and nine months ended September 30, 2001 and 2000, respectively. The proforma information includes adjustments for non-cash charges for amortization of goodwill and assembled workforce, over 60 months and 36 months, respectively. Both periods exclude a charge of $32.4 million for in-process research and development expense. The proforma information does not necessarily reflect the actual results that would have occurred nor is it necessarily indicative of future results of operations of the combined companies.

| | **Three months ended September 30,** | **Nine months ended September 30,** | |
|---|---|---|---|
| | **2000** | **2001** | **2000** |
| Net revenue | $ 15,285 | $ 68,149 | $ 34,472 |
| Net loss | (5,485) | (10,687) | (36,407) |
| Net loss per share: | | | |
| Basic and diluted | $ (0.14) | $ (0.26) | $ (1.42) |
| Weighted average shares outstanding: | | | |
| Basic and diluted | 40,031,963 | 40,862,706 | 25,602,034 |

On January 30, 2001, the Company made an investment of $7.5 million in exchange for a 19.6% equity interest in privately-held Jaldi Semiconductor Corporation ("Jaldi"). The investment is accounted for at cost and included in other assets on the balance sheet. Pixelworks and Jaldi entered into an agreement that gives Pixelworks the option to acquire the remaining interest in Jaldi in exchange for 1.85 million shares of Pixelworks common stock. Pixelworks may exercise its option at any time prior to June 30, 2002. The exercise of the option becomes mandatory if Jaldi achieves a specific development milestone before April 1, 2002, which consists of the JD1 Integrated Circuit shipping to a customer in its production implementation while meeting agreed upon cost, performance and technical specifications. Upon obtainment of the milestone by Jaldi, Pixelworks must either exercise the option within 30 days thereafter or pay Jaldi $10,000,000. As of the balance sheet date, Jaldi had not reached its development milestone, however, it is continuing to make progress towards this milestone. The Company has not assigned any value to the purchase option.

**Note 5: Recent Accounting Pronouncements**

In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* SFAS No. 133, as amended, establishes methods of accounting for derivative financial instruments and hedging activities related to those instruments as well as other hedging activities. Because we currently hold no derivative financial instruments and do not currently engage in hedging activities, adoption of SFAS No. 133 did not have any impact on our financial condition or results of operations for the three months ended September 30, 2001.

In July 2001, FASB issued SFAS Nos. 141 and 142 ("FAS 141 and 142"), *Business Combinations and Goodwill and Other Intangible Assets.* FAS 141 replaces APB 16 and eliminates pooling-of interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and 142 are effective for all business combinations initiated after June 30, 2001. Companies are required to adopt FAS 142 for fiscal years beginning after December 15, 2001. The Company will adopt FAS 142 on January 1, 2002.

FAS 141 will require, upon adoption of FAS 142, that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and to make any necessary reclassifications in order to conform with the new criteria in FAS 141 for recognition apart from goodwill. Upon adoption of FAS 142, the Company will be required to reassess the useful lives and residual values of all intangible assets acquired, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of FAS 142 within the first interim period. Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

In connection with FAS 142's transitional goodwill impairment evaluation, the Company will be required to perform an assessment of whether there is an indication that goodwill is impaired as of the date of adoption. To accomplish this, the Company must identify its reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. The Company will then have up to nine months from the date of adoption to determine the fair value of each reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and the Company must perform the second step of the transitional impairment test. In the second step, the Company must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of it assets and liabilities in a manner similar to a purchase price allocation in accordance with FAS 141, to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in the Company's statement of operations. As of the date of adoption, the Company expects to have unamortized goodwill in the amount of $68.7 million and unamortized identifiable intangible assets in the amount of $1.3 million, which will be subject to the transition provisions of FAS 141 and 142. Amortization expense related to goodwill was $11.2 million for the 9 months ended September 30, 2001. Because of the extensive effort needed to comply with adopting FAS 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on the Company's financial statements at the date of this report, including whether it will be required to recognize any transitional impairment losses as the cumulative effect of a change in accounting principle.

In August 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is required to be adopted for fiscal years beginning after June 15, 2002. The Company has not yet determined what effect this statement will have on its financial statements.

Also in August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. This new statement also supersedes certain aspects of APB 30 ("APB 30"), *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, with regard to reporting the effects of a disposal of a segment of a business and will require expected future operating losses from discontinued operations to be reported in discontinued operations in the period incurred (rather than as of the measurement date as presently required by APB 30). In addition, more dispositions may qualify for discontinued operations treatment. The provisions of this statement are required to be applied for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. The Company has not yet determined what effect this statement will have on its financial statements.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These forward-looking statements involve a number of risks and uncertainties, including those identified in the section of this Form 10-Q titled "Additional Factors That May Affect Future Results," which could cause actual results to differ from those discussed in the forward-looking statements. Forward-looking statements in this Form 10-Q are identified by words such as "believes," "expects," "anticipates," "intends," "estimates," "should," "will," "may" and similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. The forward-looking statements contained in this Form 10-Q speak only as of the date on which they are made, and the company does not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this filing. You are urged to review carefully our various disclosures in this Form 10-Q and our other reports filed with the SEC, including our 2000 Annual Report on Form 10-K filed on April 2, 2001 (the "Form 10-K"), that attempt to advise you of the risks and factors that may affect our business.

### Overview

We design, develop and market complete system-on-a-chip integrated circuits ("ICs") and software that enable the visual display of broadband content. Our technology translates and optimizes video, computer graphics, and visual Web information for display on a wide variety of electronic devices including LCD monitors, projectors, and televisions. We have announced products with Compaq, Dell, InFocus Corporation, NEC-Mitsubishi, Samsung, Sanyo, Sony and ViewSonic, and have more than 75 customers.

On May 19, 2000 we sold 5,750,000 shares of Common Stock at $10.00 per share in an Initial Public Offering ("IPO"). In June 2000, we sold a further 862,500 shares of Common Stock under the terms of the over allotment agreement relating to that Initial Public Offering. The net proceeds, amounting to approximately $60.5 million are currently invested in various marketable securities and may be used for general corporate purposes.

On January 30, 2001 we invested $7.5 million in Jaldi Semiconductor Corporation ("Jaldi"), a privately held fabless semiconductor start-up developing application specific reconfigurable Digital Signal Processing ("DSP") technology, in exchange for a minority interest in Jaldi. We have an option to purchase the remaining interest in Jaldi for 1.85 million shares of Pixelworks Common Stock. Under its agreement with Pixelworks, Jaldi is subject to one specific development milestone consisting of the JD1 Integrated Circuit shipping to a customer, in its production implementation while meeting agreed upon cost, performance and technical specifications. Upon obtainment of the milestone by Jaldi, Pixelworks must either exercise the option within 30 days thereafter or pay Jaldi $10,000,000. We intend to acquire the remaining interest upon Jaldi's successful completion of this milestone.

Also on January 30, 2001 we completed the acquisition of all of the outstanding capital stock and stock options of Panstera, Inc. ("Panstera"), a privately held fabless semiconductor company located in San Jose, California, in exchange for 4.5 million shares of Pixelworks Common Stock. The acquisition was recorded as a purchase transaction. The Company recorded a $32.4 million charge for in-process research and development ("IPR&D") related to the Panstera acquisition. Panstera is a fabless semiconductor company that is developing a broad line of mixed signal ICs that provide an end-to-end family of products for mass market, XGA resolution LCD monitors. At the time of the acquisition, Panstera did not have any products that had reached technological feasibility. Panstera had four main product groups under development at the acquisition date, each contributing from 11% to 41% to the total IPR&D value. The projects included the development of digital and analog receivers as well as digital processor ICs. The projects ranged from 50% to 85% complete. All projects had expected completion dates within one year and an estimated aggregate cost to complete of $3.2 million. The estimated completion dates of the IPR&D projects acquired from Panstera remain substantially unchanged.

We sell our products worldwide through a direct sales force and indirectly through distributors and manufacturers representatives. Distributors have been established in Japan, Taiwan and China. Manufacturers representatives support European and Korean sales. In addition to our Tualatin, Oregon corporate headquarters, we have facilities in California, Japan, Taiwan and Korea.

We recognize revenue from product sales upon shipment. Pixelworks complies with the revenue recognition guidance summarized in Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*. Reserves for sales returns and allowances are recorded at the time of shipment.

Historically, significant portions of our product revenue have been from a relatively small number of customers and distributors. Our top five customers accounted for 42.7% and 53.3% of total revenue for the nine months ended September 30, 2001 and 2000, respectively.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for 89.7% and 96.7% of total revenue for the nine months ended September 30, 2001 and 2000, respectively. Our end customers, branded manufacturers and integrators, incorporate our products into systems that are sold worldwide. All revenue to date has been denominated in U.S. dollars.

Results of Operations

Three Months Ended September 30, 2001 Compared to Three Months Ended September 30, 2000

Revenue. Revenue increased $8.8 million from $15.3 million for the three months ended September 30, 2000 to $24.1 million for the three months ended September 30, 2001, an increase of 57.5%. The increase in revenue resulted from increased shipments of PW111, PW112, PW164, PW165, and PW365 ImageProcessor ICs. All of these products, with the exception of the PW164, were products that were newly introduced and not shipping in the period ended September 30, 2000. The increase in revenue was partially offset by decreased shipments of PW264 and PW364 ImageProcessor ICs.

Gross profit. Gross profit margin was 47.6% for the three months ended September 30, 2001 compared to 41.4% for the three months ended September 30, 2000, inclusive of $10,000 and $22,000 of amortization of deferred stock compensation respectively. The improvement in gross profit margin resulted primarily from the introduction of new products with higher average gross profit margins, and fixed costs being spread over higher revenue. Approximately 32% of revenue for the three months ended September 30, 2001 was from newly introduced products that were not shipping in the three months ended September 30, 2000.

Research and development. Research and development expense, inclusive of amortization of deferred stock compensation, was $6.3 million or 26.1% of revenue for the three months ended September 30, 2001 compared to $3.3 million, or 21.8% of revenue for the three months ended September 30, 2000. The increase of $3.0 million resulted primarily from a $1.7 million increase in amortization of deferred stock compensation and $880,000 increase in compensation expenses related to an increase in personnel of 30 employees, primarily as a result of the Panstera acquisition. Upon completion of the acquisition of Panstera in January 2001, the Company recorded deferred stock compensation expense related to the unvested portion of the stock option grants to employees that were assumed by Pixelworks. The balance of the increase was primarily the result of a $410,000 increase in depreciation and amortization.

Selling, general and administrative. Selling, general and administrative expense, including amortization of deferred stock compensation, was $4.8 million, or 20.1% of revenue for the three months ended September 30, 2001 compared to $2.9 million, or 18.7% of revenue for the three months ended September 30, 2000. The most significant increase in spending resulted from an increase in personnel of 29 people that resulted in $632,000 in additional compensation expense. Primarily as a result of the acquisition of Panstera, amortization of deferred stock compensation increased $259,000. Additionally, rent expense increased $149,000 due to additional building space being rented to support higher headcount, depreciation and amortization expense increased $136,000 due to additional purchases of long-term assets, and outside services increased $184,000 primarily for legal and accounting services.

Amortization of goodwill and assembled workforce. Expenses for the amortization of goodwill and assembled workforce were $4.4 million for the three months ended September 30, 2001. At the time of the acquisition of Panstera in January 2001, the Company recorded assets of $83.6 million in goodwill, which is being amortized over sixty months, and $1.8 million in assembled workforce, which is being amortized over thirty-six months. Recent accounting pronouncements require the Company to discontinue amortizing goodwill after the fourth quarter of 2001. The Company will then be required to review goodwill for possible impairment on an annual basis beginning with the year ending December 31, 2002. The review of goodwill for impairment may result in large write-offs of goodwill.

Amortization of deferred stock compensation. Stock compensation expense was $2.5 million for the three months ended September 30, 2001, an increase of $1.9 million from $600,000 for the three months ended September 30, 2000. The increase in stock compensation expense resulted from the assumption of Panstera unvested stock option grants to employees. As a result of the acquisition of Panstera, the Company recorded $13.4 million in deferred stock compensation, which is being amortized on an accelerated method over the vesting period of the assumed stock options. Amortization of the September 30, 2001 balance of $8.8 million in deferred stock compensation is estimated to be $2.5 million for the remainder of 2001 and $4.2 million, $1.7 million, and $400,000 for the years ending December 31, 2002, 2003, and 2004, respectively.

Interest and other income and expense, net. Interest and other income and expense, net consists of interest income and other expenses. Interest income decreased $680,000 from $1.7 million for the three months ended September 30, 2000 to $997,000 for the three months ended September 30, 2001. This decrease was the result of lower yields on invested cash.

Provision for income taxes. The Company recorded no provision for income tax expense during the three months ended September 30, 2001 because the Company does not expect to have an income tax expense for the year ending December 31, 2001. As a result of the acquisition of Panstera the Company added $1.6 million in deferred tax assets, related to Panstera's NOL carry-forward, which will be offset against goodwill when utilized. The combined deferred tax assets of the Company will have a full valuation allowance established until the Company expects that it is more likely than not that the assets will be realized.

Nine Months Ended September 30, 2001 Compared to Nine Months Ended September 30, 2000

Revenue. Revenue increased $33.7 million from $34.5 million for the nine months ended September 30, 2000 to $68.1 million for the nine months ended September 30, 2001, an increase of 97.7%. The increase in revenue resulted from increased shipments of PW111, PW112, PW164, PW165, PW171, and PW365 ImageProcessor ICs. All of these products, with the exception of the PW164, were products that were newly introduced and not shipping in the period ended September 30, 2000. The increase in revenue was partially offset by decreased shipments of PW264 and PW364 ImageProcessor ICs.

Gross profit. Gross profit margin was 46.2% for the nine months ended September 30, 2001 compared to 39.4% for the nine months ended September 30, 2000, inclusive of $30,000 and $47,000 of amortization of deferred stock compensation respectively. The improvement in gross profit margin resulted primarily from the shipment of newly introduced products with higher gross profit margins, and fixed costs being spread over higher revenue. Gross profit margins also improved as a result of an increased percentage of mature products whose gross profit margins were higher than average.

Research and development. Research and development expense, inclusive of amortization of deferred stock compensation, was $18.0 million or 26.5% of revenue for the nine months ended September 30, 2001 compared to $7.8 million, or 22.5% of revenue for the nine months ended September 30, 2000. The increase of $10.2 million resulted primarily from an increase in amortization of deferred stock compensation of $4.5 million and a $2.9 million increase in compensation expenses related to an increase in personnel of 30 employees, primarily as a result of the Panstera acquisition, a $1.1 million increase in depreciation and amortization due to purchases of long-term assets, and a $1.3 million increase in expenses related to engineering consulting and development services for products in development.

Selling, general and administrative. Selling, general and administrative expense, inclusive of amortization of deferred stock compensation, was $13.5 million, or 19.9% of revenue for the nine months ended September 30, 2001 compared to $7.4 million, or 21.4% of revenue for the nine months ended September 30, 2000. Most of the $6.1 million increase resulted from a $2.0 million increase in compensation expenses related to an increase in personnel of 29 employees and an increase in amortization of deferred stock compensation of $744,000 primarily as a result of the acquisition of Panstera. The balance of the increase consisted of an increase of $395,000 in sales commissions, $419,000 increase in rent due to increased building space to support additional headcount, a $298,000 increase in insurance, a $289,000 increase in accounting and legal expenses, a $351,000 increase in depreciation and amortization, and $335,000 increase in travel as a result of an increase in the number of customer visits and investor relations activities.

Amortization of goodwill and assembled workforce. Expenses for the amortization of goodwill and assembled workforce were $11.6 million for the nine months ended September 30, 2001. At the time of the acquisition of Panstera in January 2001, the Company recorded assets of $83.6 million in goodwill, which is being amortized over sixty months, and $1.8 million in assembled workforce, which is being amortized over thirty-six months. The Company began amortizing these assets in February 2001.

Patent settlement expense. The Company recorded a one-time charge in February 2000 related to the settlement of a patent dispute. Under the terms of the settlement agreement, the Company entered into a perpetual license agreement with InFocus Systems, Inc. for the use of its technology specified in two patents held by InFocus in exchange for $2.4 million in cash and 156,863 shares of the Company's Series D preferred stock, valued at $12.75 per share. An additional $753,000 of the patent settlement expense was recorded based on the difference between the estimated fair value of the underlying common stock and the Series D conversion price of $8.50 per share. Pixelworks received a release of any claims InFocus may have against Pixelworks relating to these patents.

Amortization of deferred stock compensation. Stock compensation expense was $6.9 million for the nine months ended September 30, 2001, an increase of $5.3 million from $1.6 million for the nine months ended September 30, 2000. The increase in stock compensation expense is the result of the assumption of Panstera unvested stock option grants to employees. As a result of the acquisition of Panstera, the Company recorded $13.4 million in deferred stock compensation, which is being amortized on an accelerated method over the vesting period of the assumed stock options.

Interest and other income and expense, net. Interest and other income and expense, net consists of interest income, interest expense and other income. Interest and other income and expense, net increased $751,000 from $2.8 million for the nine months ended September 30, 2000 to $3.6 million for the nine months ended September 30, 2001. This increase was primarily related to an increase in interest income of $689,000 that resulted from higher average cash balances as a result of proceeds from the initial public offering in May 2000 off-set by lower yields on invested cash in the current year.

Provision for income taxes. The Company recorded no provision for income tax expense during the nine months ended September 30, 2001 because the Company does not expect to have an income tax expense for the year ending December 31, 2001.

Liquidity and Capital Resources

As of September 30, 2001, the Company had cash and cash equivalents of $61.9 million and working capital of $100.0 million as compared to cash and cash equivalents of $49.7 million and working capital of $100.4 million as of December 31, 2000. Principal sources of cash during the nine months ended September 30, 2001 were proceeds from the maturities of marketable securities, net of purchases of marketable securities, of $18.7 million, cash generated by operating activities of $5.3 million and proceeds from the issuance of stock under the Company's employee stock purchase plan and stock option plans of $1.6 million. Principal uses of cash during the nine months ended September 30, 2001 were the investment in Jaldi Semiconductor of $7.5 million and property and equipment expenditures and purchases of other assets of $5.8 million.

Accounts Receivable. Accounts receivable increased to $8.5 million at September 30, 2001 from $6.6 million at December 31, 2000, an increase of $1.9 million. The increase in accounts receivable was the result of increased shipments. Average days sales outstanding ("DSO") were 32 and 33 days at September 30, 2001 and December 31, 2000, respectively.

Inventories. Inventories increased from $3.3 million at December 31, 2000 to $3.7 million at September 30, 2001, an increase of $400,000. Inventory turns were 11 and 13 at September 30, 2001 and December 31, 2000, respectively. An inventory turn of 11 represents approximately 5 weeks of shipments in inventory.

Prepaid Expenses and Other Current Assets. Prepaid expenses and other current assets increased $2.7 million from December 31, 2000 to September 30, 2001. This increase was primarily due to an increase in prepaid insurance, prepaid royalties and prepaid annual software maintenance fees.

Long-Term Marketable Securities and Other Assets. Long-term marketable securities consisting of a corporate bond with 12 months remaining to maturity were $2.3 million at September 30, 2001. The Company invested proceeds from the maturity of short-term marketable securities into long-term marketable securities in 2001 to take advantage of the more favorable interest rates.

Other assets increased $8.1 million from December 31, 2000 to September 30, 2001. The increase was primarily the result of a $7.5 million investment in Jaldi Semiconductor Corporation on January 31, 2001.

As of September 30, 2001, principal commitments consisted of obligations outstanding under operating leases. These commitments include leases for approximately 46,000 square feet in two facilities located in Tualatin, Oregon, expiring through 2006. In connection with the acquisition of Panstera, the Company has assumed the leases of two facilities in San Jose, CA for approximately 8,958 square feet. The total annual estimated costs for these commitments are $926,000, $1.2 million, $1.1 million, $572,000, $352,000 and $59,000 for the years ending December 31, 2001, 2002, 2003, 2004, 2005 and 2006, respectively. Although the Company has no other material commitments, we anticipate a substantial increase in our capital expenditures consistent with anticipated growth in our operations, infrastructure and personnel. In the future we may also require a larger inventory of products in order to support anticipated growth in our business.

Upon Jaldi's successful completion of specific development milestones, the Company has an option to purchase the remaining interest in Jaldi for 1.85 million shares of Pixelworks stock, or will incur a breakup fee of $10,000,000 if the option is not exercised if required.

The Company believes that its existing cash and cash equivalents and funds generated from operations will be sufficient to fund its operations 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.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* SFAS No. 133, as amended, establishes methods of accounting for derivative financial instruments and hedging activities related to those instruments as well as other hedging activities. Because we currently hold no derivative financial instruments and do not currently engage in hedging activities, adoption of SFAS No. 133 did not have any impact on our financial condition or results of operations for the three months ended September 30, 2001.

In July 2001, FASB issued SFAS Nos. 141 and 142 ("FAS 141 and 142"), *Business Combinations and Goodwill and Other Intangible Assets.* FAS 141 replaces APB 16 and eliminates pooling-of interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and 142 are effective for all business combinations initiated after June 30, 2001. Companies are required to adopt FAS 142 for fiscal years beginning after December 15, 2001. The Company will adopt FAS 142 on January 1, 2002.

FAS 141 will require, upon adoption of FAS 142, that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and to make any necessary reclassifications in order to conform with the new criteria in FAS 141 for recognition apart from goodwill. Upon adoption of FAS 142, the Company will be required to reassess the useful lives and residual values of all intangible assets acquired, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of FAS 142 within the first interim period. Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

In connection with FAS 142's transitional goodwill impairment evaluation, the Company will be required to perform an assessment of whether there is an indication that goodwill is impaired as of the date of adoption. To accomplish this, the Company must identify its reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. The Company will then have up to nine months from the date of adoption to determine the fair value of each reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and the Company must perform the second step of the transitional impairment test. In the second step, the Company must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of it assets and liabilities in a manner similar to a purchase price allocation in accordance with FAS 141, to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in the Company's statement of operations. As of the date of adoption, the Company expects to have unamortized goodwill in the amount of $68.7 million and unamortized identifiable intangible assets in the amount of $1.3 million, which will be subject to the transition provisions of FAS 141 and 142. Amortization expense related to goodwill was $11.2 million for the 9 months ended September 30, 2001. Because of the extensive effort needed to comply with adopting FAS 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on the Company's financial statements at the date of this report, including whether it will be required to recognize any transitional impairment losses as the cumulative effect of a change in accounting principle.

In August 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is required to be adopted for fiscal years beginning after June 15, 2002. The Company has not yet determined what effect this statement will have on its financial statements.

Also in August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. This new statement also supersedes certain aspects of APB 30 ("APB 30"), *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, with regard to reporting the effects of a disposal of a segment of a business and will require expected future operating losses from discontinued operations to be reported in discontinued operations in the period incurred (rather than as of the measurement date as presently required by APB 30). In addition, more dispositions may qualify for discontinued operations treatment. The provisions of this statement are required to be applied for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. The Company has not yet determined what effect this statement will have on its financial statements.

Additional Factors That May Affect Future Results

**RISKS RELATED TO OUR OPERATIONS**

**We have incurred net losses since our inception, and we may not achieve or sustain annual profitability.**

We incurred net losses of approximately $40.6 million during the first nine months of 2001 and approximately $567,000, $4.9 million and $1.6 million and in 2000, 1999 and 1998, respectively. In the future we expect our research and development and selling, general and administrative expenses to increase. Although we were profitable in the second, third and fourth quarters of 2000, we have and will incur substantial non-cash charges relating to the January 2001 acquisition of Panstera, Inc. that will make it very likely that we will again experience a net loss in 2001. 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 are likely to vary significantly in the future based on a number of factors related to our industry and the markets for our products, some of which are not in our control and any of which may cause the price of our common stock to fluctuate. These factors include:

- demand for flat panel monitors, advanced television displays, multimedia projectors and Internet appliances;
- demand for our products and the timing of orders for our products;
- the deferral of customer orders in anticipation of our new products or product enhancements or due to a reduction in our customers' end 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 personal computer, display and semiconductor markets.

These factors are difficult 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 likely 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 highly integrated products and high-speed mixed signal products are difficult to manufacture without defects and the existence of defects in the manufactured products 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 our products are more highly integrated than many 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 IC's in certain customer system applications that required us to institute additional IC level testing. As a result of these field failures we have incurred additional costs due to customers returning potentially affected products. Additionally, customers have experienced delays in receiving product shipments from us which resulted in the loss of revenue and profits.

**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 devices 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.

**Because of the complex nature of our semiconductor designs and the associated manufacturing process and the rapid evolution of our customers' product design 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, 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. Since commencing our operations, we have experienced increased development time and delays in introducing new products. We will not always succeed in developing new products or product enhancements nor do so in a timely manner. With the addition of Panstera, we 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 that were formerly done in one location.

Many of the Panstera designs involve the development of new high-speed analog circuits that are difficult to simulate and 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 and 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. During the first nine months of 2001 sales to distributors represented 59.2% of total revenue and during 2000 sales to distributors represented 64.0% of total revenue for the year. During the first nine months of 2001 and for fiscal 2000, sales to Tokyo Electron Device Limited, our distributor in Japan, represented 52.0% and 58.9%, respectively, of our total revenue. For the first nine months of 2001 and during 2000 sales through Tokyo Electron Device to our customer Seiko Epson Corporation represented approximately 11.6% and 16.6%, respectively, of our total revenue. Sale to our top five customers during the first nine months of 2001 accounted for approximately 42.7% of our total sales. Sales to our top five customers accounted for approximately 51.7%, 62.3% and 89.3% for the years ended December 31, 2000, 1999 and 1998 respectively. As a result of this customer and distributor 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 distributors that sell our products to display manufacturers and their suppliers.

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

At September 30, 2001, accounts receivable from Tokyo Electron Device represented 38.8% of our total accounts receivable. The failure of this distributor to pay these accounts receivable would result in a significant expense that would seriously harm our operating results and would reduce our cash flows.

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

Sales outside of the U.S. accounted for 89.7% during the first nine months of 2001 and 95.5%, 92.8% and 51.1% of our total revenue in 2000, 1999 and 1998, respectively. Most of our customers are concentrated in Japan, Korea and Taiwan, with aggregate sales from those three countries accounting for 88.0% of our total revenue during the year ended December 31, 2000 and 81.3% during the first nine months of 2001. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenues in future periods. In addition, customers who incorporate our products into their products sell them outside of the U.S., thereby exposing us indirectly to foreign risks. In addition, all of our products are manufactured outside of the U.S. We are, therefore, subject to many international risks, including:

- 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 Asian financial crisis that occurred in 1998 which caused a devaluation in the currencies of Japan, Taiwan and Korea resulting 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 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 of the display processor industry and our display processor products;

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

- difficulties in collecting accounts receivable.

**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 are an intermediary 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 credit worthiness 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 manufactures for our products exposes us to shortages based on capacity allocation, 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 electrical 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 in the future. We have an agreement with a third party contract manufacturer which covers quantity and pricing terms relating to the manufacture of certain of our semiconductors. Other than this agreement, we do not have a long-term supply contract with any of our other contract manufacturers, and they are not obligated to supply us with products for any specific period, 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 canceled, expected revenues will 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, or suffer declines in our gross margin.

**We recently assumed more responsibility for the manufacturing of our products that, if not implemented successfully, could result in increased costs or a reduction or loss of revenue.**

We recently assumed greater responsibility for the process for our next-generation of products by subcontracting separately for the production of wafers and for their assembly and testing. We are building some 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 have recently become subject to increased risks arising from wafer manufacturing yields and associated with coordination of the manufacturing, assembly and testing process. While the percentage of our revenue coming from products recently introduced using this process has been relatively small to-date, we expect that revenues using a COT process will become significant in the future. Failure to effectively implement this approach to manufacturing properly would reduce our revenues and harm our gross margin and results of operations.

**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.

**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.**

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 processes 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 could seriously harm our business. Particularly, 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. In particular, the loss of the services of Allen Alley, our President, Chief Executive Officer and Chairman, Michael West, our Vice President, Technology, or Robert Greenberg, our Vice President, Product Development and Customer Support, could materially and adversely affect us. We are currently planning to hire a significant number of additional employees this year and in future periods, and 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, which 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 we or our customers overestimate demand, we may purchase products which we may not be able to sell. As a result, we would have excess inventory, which would increase our losses. Conversely, if we or our customers underestimate demand or if sufficient manufacturing capacity is unavailable, we would forego revenue opportunities, lose market share and damage our customer relationships.

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

We have development arrangements with customers and other parties such as Intel Corporation that consume large amounts of engineering resources far in advance of product revenue. Our work under these arrangements is technically challenging and may require deliverables on an accelerated basis. These arrangements place 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. For example, during 2000 we developed reference designs supporting next generation flat panel monitors at the request of a key monitor customer. After approximately six months of concentrated development effort, the program to market these monitors was cancelled by the customer and resulted in no revenue.

In addition, allocating significant resources to these arrangements may detract from or delay the completion of other important development projects. Any of these development agreements 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 prior to generating associated revenues. Because the development of our products incorporates not only our complex and evolving technology, but 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. However, even when we achieve a design win, the customer may never ship systems incorporating our products. Because of our relatively limited history in selling our products, we cannot assure you that the time required for the testing, evaluation and design of our products by our customers will 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.

**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 companies that used our products experienced delays in the availability of key components from other suppliers, which, in turn, threatened a delay in demand for the products that we supplied to them.

**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 board 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, all 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. Recent 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. Our current products are developed using Visual C, a popular software development language. However, 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 us and our customers, errors 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.

**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.**

Our current manufacturers and most of our customers are located in 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. In September 1999, a current manufacturer's facilities were affected by a significant earthquake in Taiwan. As a consequence of this earthquake, this manufacturer suffered power outages and disruption that impaired its production capacity. Earthquakes, fire, flooding 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 foundry partners' assembly capacity. Any disruption resulting from extraordinary events could cause significant delays in shipments of our solutions until we are able to shift our manufacturing or assembling 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.

**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 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 the InFocus patents. As a result, we recorded a one-time charge of $4.1 million 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; and

- attempt to redesign those products that contain the allegedly infringing intellectual property.

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 have twelve 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. 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. Competitors in both the United States and foreign countries, many of which 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.

**Any acquisition or equity investment we make could disrupt our business and severely harm our financial condition.**

We intend to continue to consider investments in or acquisitions of complementary businesses, products or technologies. For example, in January 2001 we completed the acquisition of Panstera, Inc. in exchange for 4.5 million shares of Pixelworks Common Stock. We also made a strategic investment in Jaldi Semiconductor Corporation in January 2001 for $7.5 million with the intent to acquire the remainder of the company for 1.85 million shares of Pixelworks Common Stock contingent upon the satisfactory completion of certain milestones by Jaldi Semiconductor Corporation. The acquisition of Panstera and investment in Jaldi contain a very high level of risk primarily because the investments were made based on in-process technological development that may not be completed, or if completed, may not be commercially viable. If this were the case, our financial results would likely be very negatively affected.

These and any future acquisitions and investments could result in:

- issuance of stock that dilutes current stockholders' percentage ownership;

- incurrence of debt;

- assumption of liabilities;

- amortization expenses related to goodwill and other intangible assets; or

- large and immediate write-offs.

Our operation of any acquired business will also involve numerous risks, including:

- 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.

**Goodwill represents a significant portion of the Company's total assets.**

Goodwill represents a significant portion of the Company's total assets and the amortization of goodwill will have a material adverse effect on reported results of operations through at least the end of 2001, and possibly beyond. As of September 30, 2001, goodwill amounted to $73.0 million, or approximately 36%, of the Company's total assets. Currently, the Company anticipates amortizing goodwill at a rate of $4.2 million per quarter in the fourth quarter of 2001, which will have a material adverse effect on the Company's reported results of operations. While recent accounting pronouncements require the Company to discontinue amortizing goodwill after the fourth quarter of 2001, it will then be required to review goodwill for possible impairment on an annual basis beginning with the year ending December 31, 2002. The review of goodwill for impairment may result in large write-offs of goodwill, which could have a material adverse effect on results of operations.

**Failure to manage our expansion effectively could adversely affect our ability to increase our business and 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 substantially. We grew from 72 employees on January 1, 2000, to 165 employees on September 30, 2001. In addition, we are currently planning to hire a significant number of additional employees in the second half of this year. 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, 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 will 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 business would be seriously harmed.

**RISKS RELATED TO OUR INDUSTRY**

**Failure of consumer demand for flat panel displays and other display technologies to increase could impede our growth.**

Our product development strategies anticipate that consumer demand for flat panel displays and other emerging display products will increase in the future. The success of our products is dependent on increased demand for these products, which are at early stages of development. The potential size of the flat panel display market 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 flat panel displays must be widely available and affordable to consumers. In the past, the supply of advanced flat panel displays has been cyclical. We expect this pattern to continue. Under-capacity in the advanced flat panel 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 advanced flat panel displays. In addition, advance flat panel display prices may remain high because of limited supply, and consumer demand may not grow if the supply of advanced flat panel displays does not increase.

**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 a range of specialized and diversified electronic and semiconductor companies that offer display processors. In particular, we compete against Genesis Microchip, Inc., Macronix International Co., Ltd., Sage, Inc., Silicon Image, Inc., SmartASIC, Inc., STMicroelectronics NV, and other companies. Potential competitors may include diversified semiconductor manufacturers including Broadcom Corporation, National Semiconductor Corp., Philips, Texas Instruments, Inc. and other diversified semiconductor companies. We also compete in some instances against in-house processing solutions designed by our customers. 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 faster 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. In addition, start-up companies may seek to compete in our markets. 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 market for Internet appliances may not evolve rapidly enough to support expanded market acceptance of our products and industry standards in this market continue to evolve.**

If the emerging market for Internet appliances does not develop or does not evolve fast enough to support rapid market acceptance of our products, our business, financial condition and results of operations will be materially and adversely affected. The Internet appliance market includes netTVs, screenphones, e-mail terminals, Web terminals and tablets. Our success will depend on our ability to achieve design wins with customers developing new products and enhanced products for the Internet appliance market and their ability to successfully introduce and promote these products. There can be no assurance that the Internet appliance market will develop to the extent or in the timeframes necessary to support expansion of our business. We anticipate that Internet appliance products will be generally based on industry standards, which are continually evolving. The emergence of new industry standards could render our products or our customers products unmarketable or obsolete and we may incur substantial unanticipated costs to comply with any new standards. Moreover, our past sales have resulted, to a significant extent, from our ability to anticipate changes in technology and industry standards and to develop and introduce new and enhanced products addressing changes within our industry. Our continued ability to adapt to industry changes and to anticipate future standards, and the rate of adoption and acceptance of those standards, will be a significant factor in maintaining or improving our competitive position and our prospects for growth. There can be no assurance that we will be able to anticipate the evolving standards in the semiconductor industry and, in particular, the applications in the Internet appliance market, or that we will be able to successfully develop and introduce new products into this market.

**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.**

The anti-takeover provisions of Oregon law and our articles of incorporation may make a change in control of our business more difficult, even if a change in control would be beneficial to the shareholders. These provisions may allow the board of directors to prevent changes in the management and control of our business. Under Oregon law, our board of directors may adopt additional anti-takeover measures in the future. One anti-takeover provision that we have is the ability of our board of directors to determine the terms of preferred stock and issue preferred stock without the approval of the holders of the common stock. At this time, there are no shares of preferred stock outstanding. However, because the rights and preferences of any series of preferred stock may be set by the board of directors in its sole discretion without approval of the holders of the common stock, the rights and preferences of this preferred stock may be superior to those of the common stock. Accordingly, the rights of the holders of common stock may be adversely affected.

**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 10,910,625 shares or approximately 26.4% of our outstanding common stock as of September 30, 2001. 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;
- 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 like us have been highly volatile recently. 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 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.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Our primary market risk exposure is the impact of interest rate fluctuations on interest income earned on our investment portfolio. The risks associated with market, liquidity and principal are mitigated 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. We currently have no debt instruments or credit facilities.

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 any of our sales. We do not currently hedge against foreign currency rate fluctuations. The effect of an immediate 10% change in exchange rates would not have a material impact on our future operating results or cash flows.

## PART II - OTHER INFORMATION

**Item 6: Exhibits and Reports on Form 8-K**

**(a) Exhibits**

None

**(b) Reports on Form 8-K**

During the three-month period ending September 30, 2001, there were no reports on Form 8-K filed.

**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.

Date: November 13, 2001

/s/ JEFFREY B. BOUCHARD

Jeffrey B. Bouchard
*Vice President, Finance and Chief Financial Officer*
*(Principal Financial and Accounting Officer)*