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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008.

or

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

For the transition period from _____ to _____.

Commission File Number: 000-30269

PIXELWORKS, INC.

(Exact name of registrant as specified in its charter)

OREGON

(State or other jurisdiction of incorporation)

91-1761992

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

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

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

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

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

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

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

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

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008
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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,780	\$ 74,572
Short-term marketable securities	18,560	34,581
Accounts receivable, net	5,948	6,223
Inventories, net	5,257	11,265
Prepaid expenses and other current assets	3,771	3,791
Total current assets	76,316	130,432
Long-term marketable securities	1,490	9,804
Property and equipment, net	4,839	6,148
Other assets, net	5,387	6,902
Debt issuance costs, net	764	2,260
Acquired intangible assets, net	4,091	6,370
Total assets	<u>\$ 92,887</u>	<u>\$ 161,916</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 4,541	\$ 3,992
Accrued liabilities and current portion of long-term liabilities	7,396	13,848
Current portion of income taxes payable	—	232
Total current liabilities	11,937	18,072
Long-term liabilities, net of current portion	1,501	1,236
Income taxes payable, net of current portion	10,866	10,635
Long-term debt	60,634	140,000
Total liabilities	84,938	169,943
Commitments and contingencies		
Shareholders' equity (deficit):		
Preferred stock	—	—
Common stock	334,127	333,934
Shares exchangeable into common stock	—	113
Accumulated other comprehensive loss	(1,984)	(4,778)
Accumulated deficit	(324,194)	(337,296)
Total shareholders' equity (deficit)	7,949	(8,027)
Total liabilities and shareholders' equity	<u>\$ 92,887</u>	<u>\$ 161,916</u>

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue, net	\$ 21,479	\$ 28,133	\$ 66,248	\$ 79,010
Cost of revenue (1)	10,028	16,025	32,628	45,447
Gross profit	11,451	12,108	33,620	33,563
Operating expenses:				
Research and development (2)	6,476	8,962	20,391	30,612
Selling, general and administrative (3)	4,413	5,697	13,590	20,235
Restructuring	121	1,645	971	7,048
Amortization of acquired intangible assets	—	89	164	269
Total operating expenses	11,010	16,393	35,116	58,164
Income (loss) from operations	441	(4,285)	(1,496)	(24,601)
Gain on repurchase of long-term debt, net	8,113	—	19,670	—
Interest income	405	1,454	1,941	4,425
Interest expense	(343)	(658)	(1,335)	(2,003)
Amortization of debt issuance costs	(83)	(165)	(354)	(496)
Other income	—	—	218	—
Other-than-temporary impairment of marketable security	—	—	(6,490)	—
Interest and other income, net	8,092	631	13,650	1,926
Income (loss) before income taxes	8,533	(3,654)	12,154	(22,675)
Provision (benefit) for income taxes	314	775	(948)	1,796
Net income (loss)	\$ 8,219	\$ (4,429)	\$ 13,102	\$ (24,471)
Net income (loss) per share:				
Basic	\$ 0.57	\$ (0.27)	\$ 0.90	\$ (1.50)
Diluted	\$ 0.56	\$ (0.27)	\$ 0.89	\$ (1.50)
Weighted average shares outstanding:				
Basic	14,383	16,307	14,629	16,284
Diluted	15,399	16,307	14,640	16,284
(1) Includes:				
Amortization of acquired developed technology	\$705	\$705	\$2,115	\$2,115
Stock-based compensation	8	22	46	70
Restructuring	—	11	—	147
(2) Includes stock-based compensation	177	538	1,075	1,718
(3) Includes stock-based compensation	227	684	965	2,633

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ 13,102	\$(24,471)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on repurchase of long-term debt, net	(19,670)	—
Other-than-temporary impairment of marketable security	6,490	—
Depreciation and amortization	5,007	10,982
Amortization of acquired intangible assets	2,279	2,384
Stock-based compensation	2,086	4,421
Deferred income tax expense (benefit)	(476)	420
Amortization of debt issuance costs	354	496
Accretion on short- and long-term marketable securities	(325)	(320)
Loss on asset disposals	93	210
Write-off of certain assets related to restructuring	14	679
Other	40	41
Changes in operating assets and liabilities:		
Accounts receivable, net	275	646
Inventories, net	6,008	(1,703)
Prepaid expenses and other current and long-term assets, net	759	3,326
Accounts payable	(390)	(934)
Accrued current and long-term liabilities	(2,459)	(1,822)
Income taxes payable	(1)	(412)
Net cash provided by (used in) operating activities	<u>13,186</u>	<u>(6,057)</u>
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	43,964	52,221
Purchases of marketable securities	(22,999)	(27,837)
Purchases of property and equipment	(1,478)	(2,027)
Proceeds from sales of property and equipment	20	26
Net cash provided by investing activities	<u>19,507</u>	<u>22,383</u>
Cash flows from financing activities:		
Repurchase of long-term debt	(58,554)	—
Payments on asset financings	(3,925)	(6,130)
Repurchase of common stock	(2,053)	—
Proceeds from issuances of common stock	47	352
Net cash used in financing activities	<u>(64,485)</u>	<u>(5,778)</u>
Net change in cash and cash equivalents	(31,792)	10,548
Cash and cash equivalents, beginning of period	<u>74,572</u>	<u>63,095</u>
Cash and cash equivalents, end of period	<u>\$ 42,780</u>	<u>\$ 73,643</u>

See accompanying notes to condensed consolidated financial statements.

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

NOTE 1: BASIS OF PRESENTATION

Nature of Business

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

Condensed Consolidated Financial Statements

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

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

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

Use of Estimates

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

Reclassifications

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

NOTE 2: BALANCE SHEET COMPONENTS**Marketable Securities**

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

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

Accounts Receivable, Net

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

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

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

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

Inventories, Net

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

Inventories, net consists of the following:

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

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

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

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

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of current prepaid expenses, deposits, income taxes receivable, other receivables and deferred tax assets. In the third quarter of 2008 we increased the estimated amortization rate of a certain prepaid royalty due to a change in future product design. The revision will be made prospectively and had no impact on our condensed statements of operations, balance sheets or cash flows as of September 30, 2008.

Property and Equipment, Net

Property and equipment, net consists of the following:

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

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Acquired Intangible Assets, Net

Acquired intangible assets, net consists of the following:

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

Estimated future amortization of acquired developed technology is as follows:

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

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

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

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

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

Long-Term Debt

In 2004, we issued \$150,000 of 1.75% convertible subordinated debentures (the “debentures”) due 2024. In February 2006, we repurchased and retired \$10,000 of the debentures. In February 2008, we repurchased and retired \$50,248 of the debentures in a modified dutch auction tender offer for \$37,939 in cash. We recognized a net gain of \$11,557 on the repurchase, which included a \$13,064 discount, offset by legal and professional fees of \$755 and a write-off of debt issuance costs of \$752. In August 2008, we repurchased and retired \$29,118 of the debentures for \$20,615 in a combination of open market and private transactions. We recognized a net gain of \$8,113 on the repurchases, which included an \$8,503 discount, offset by a write-off of debt issuance costs of \$390.

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

We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the \$60,634 debentures outstanding at each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019, at a purchase price equal to 100% of the principal amount plus accrued and unpaid interest. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

Shareholders' Equity (Deficit)

Reverse Stock Split

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

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

Share Repurchase Program

In September 2007, the Board of Directors authorized the repurchase of up to \$10,000 of our common stock over the next twelve months. In August 2008, the Board of Directors approved an extension to the program for an additional twelve months, through September 2009. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion. Share repurchases under the program may be made through open market and privately negotiated transactions at our discretion, subject to market conditions and other factors. During 2007, we repurchased 1,260,833 common shares at a cost of \$4,269. During the first nine months of 2008, we repurchased 1,031,437 shares for \$2,053. As of September 30, 2008, \$3,678 remained available for repurchase under the plan. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

NOTE 3: FAIR VALUE MEASUREMENT

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

- Level 1: Valuations based on quoted prices in active markets for identical assets and liabilities.
- Level 2: Valuations based on observable inputs other than quoted prices in active markets for identical assets and liabilities.
- Level 3: Valuations based on unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

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

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

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

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

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

NOTE 4: RESTRUCTURING PLANS

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

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

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

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

NOTE 5: INCOME TAXES

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

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

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

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

NOTE 6: COMPREHENSIVE INCOME (LOSS)

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

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

NOTE 7: EARNINGS PER SHARE

We calculate earnings per share in accordance with SFAS 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and include exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 by Jaldi, our Canadian subsidiary, to its shareholders in connection with the Jaldi asset acquisition, have characteristics essentially equivalent to Pixelworks' common stock. As of January 31, 2008 all exchangeable shares had been exchanged for shares of Pixelworks, Inc. common stock. Basic and diluted weighted average shares outstanding have been calculated to reflect the June 4, 2008 one-for-three reverse stock split in all periods presented.

Diluted weighted average shares outstanding includes the incremental number of common shares that would be outstanding assuming the exercise of certain stock options, when such exercise would have the effect of reducing earnings per share, and the conversion of our convertible debentures, using the

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if-converted method, when such conversion is dilutive. If our convertible debentures are dilutive, interest expense and amortization of debt issuance costs, net of tax, are added to net income used in calculating basic net income per share to arrive at net income used in calculating diluted net income per share.

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

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

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

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

NOTE 8: SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental disclosure of cash flow information is as follows:

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	Nine Months Ended September 30,	
	2008	2007
Cash paid during the period for:		
Interest	\$ 1,341	\$ 1,388
Income taxes	46	101

Non-cash investing and financing activities:

Acquisitions of property and equipment and other assets under extended payment terms	\$ 1,138	\$ 395
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NOTE 9: SEGMENT INFORMATION

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

Geographic Information

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

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

Significant Customers

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

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

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

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

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

NOTE 10: RISKS AND UNCERTAINTIES

Concentration of Suppliers

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

Risk of Technological Change

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

Concentrations of Credit Risk

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

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

NOTE 11: COMMITMENTS AND CONTINGENCIES

Indemnifications

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

Legal Proceedings

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

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

Forward-looking Statements

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

Overview

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

Results of Operations

Revenue, net

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

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

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

Multimedia Projector

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

Advanced Television

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

Advanced Media Processor

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

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

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

LCD Monitor, Panel and Other

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

Cost of revenue and gross profit

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

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

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

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

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

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

Research and development

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

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

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

¹ Includes stock-based compensation expense of:

177

538

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

- Depreciation and amortization expense decreased \$1.4 million. This decrease is primarily due to the December 31, 2007 write-off of engineering software tools, which we are no longer using due to reductions in research and development personnel and changes in product development strategy.
- Compensation expense decreased \$543,000. At September 30, 2008, we had 130 research and development employees compared to 188 at September 30, 2007.
- Stock-based compensation expense decreased \$361,000 due to personnel reductions and reduced valuation of our stock options.
- Facilities and information technology expense allocations decreased \$294,000, primarily due to decreases in equipment depreciation and compensation expense.

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

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

¹ Includes stock-based compensation expense of:

1.075

1.718

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

- Depreciation and amortization expense decreased \$5.2 million. This decrease is primarily due to the December 31, 2007 write-off of engineering software tools.
- Compensation expense decreased \$2.3 million due to fewer research and development personnel.
- Facilities and information technology expense allocations decreased \$1.4 million, primarily due to reductions in outsourced IT support, lower rent and decreased equipment depreciation.
- Stock-based compensation expense decreased \$643,000 due to personnel reductions and reduced valuation of our stock options.
- Travel and related expenses decreased \$571,000.

Selling, general and administrative

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

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

	Three months ended September 30,		2008 v 2007	
	2008	2007	\$ change	% change
Selling, general and administrative ¹	\$ 4,413	\$ 5,697	\$(1,284)	(23)%

¹ Includes stock-based compensation expense of:

227

684

Selling, general and administrative expense decreased 23% in the third quarter of 2008 compared with the third quarter of 2007. The decrease in selling, general and administrative expense is directly attributable to the restructuring efforts that we initiated in 2006. These efforts resulted in the following expense reductions:

- Compensation expense decreased \$586,000. As of September 30, 2008, we had 73 employees in selling, general and administrative functions, compared to 85 as of September 30, 2007.
- Stock-based compensation expense decreased \$457,000 due to personnel reductions and reduced valuation of our stock options.

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

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	Nine months ended September 30,		2008 v 2007	
	2008	2007	\$ change	% change
Selling, general and administrative ¹	\$13,590	\$20,235	\$(6,645)	(33)%

¹ Includes stock-based compensation expense of:

965 2,633

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

- Compensation expense decreased \$3.1 million due to fewer selling, general and administrative personnel.
- Stock-based compensation expense decreased \$1.7 million due to personnel reductions and reduced valuation of our stock options.
- Facilities and information technology allocations decreased \$725,000.
- Travel and related expenses decreased \$524,000.

Restructuring

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Termination and retention benefits ¹	\$ 107	\$ 1,116	\$ 463	\$ 4,766
Consolidation of leased space ²	14	475	508	1,366
Net write-off of assets and reversal of related liabilities	—	107	—	662
Payments, non-cancelable contracts	—	—	—	313
Other	—	(42)	—	88
Total restructuring expenses	\$ 121	\$ 1,656	\$ 971	\$ 7,195
Included in cost of revenue	\$ —	\$ 11	\$ —	\$ 147
Included in operating expenses	121	1,645	971	7,048

¹ Termination and retention benefits related to our restructuring plans included severance and retention payments for terminated employees and retention payments for certain continuing employees.

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

Amortization of acquired intangible assets

Amortization of acquired intangible assets relates to a customer relationship asset that we recorded in connection with our June 2005 Equator acquisition. The asset was fully amortized as of June 30, 2008 and there was no amortization expense during the third quarter of 2008. Amortization of the customer

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relationship asset was \$89,000 for the third quarter of 2007 and \$164,000 and \$269,000 for the first nine months of 2008 and 2007, respectively.

Interest and other income, net

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

	Three months ended September 30,			Nine months ended September 30,		
	2008	2007	\$ change	2008	2007	\$ change
Gain on repurchase of long-term debt, net ¹	\$ 8,113	\$ —	\$ 8,113	\$ 19,670	\$ —	\$ 19,670
Interest income ²	405	1,454	(1,049)	1,941	4,425	(2,484)
Interest expense ³	(343)	(658)	315	(1,335)	(2,003)	668
Amortization of debt issuance costs ⁴	(83)	(165)	82	(354)	(496)	142
Other-than-temporary impairment of marketable security, net ⁵	—	—	—	(6,490)	—	(6,490)
Other income ⁶	—	—	—	218	—	218
Total interest and other income, net	<u>\$ 8,092</u>	<u>\$ 631</u>	<u>\$ 7,461</u>	<u>\$ 13,650</u>	<u>\$ 1,926</u>	<u>\$ 11,724</u>

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

² Interest income is earned on cash equivalents and short- and long-term marketable securities. The decrease in the 2008 periods is due to lower balances of marketable securities, which resulted from our 2008 repurchases of long-term debt and decreased yields on our invested funds.

³ Interest expense primarily relates to interest payable on our long-term debt. The decrease in the 2008 periods is due to the reduced outstanding principal balance which resulted from our 2008 repurchases of long-term debt.

⁴ The fees associated with the 2004 issuance of our long-term debt have been capitalized and are being amortized over a period of seven years. The remaining amortization period is approximately three years as of September 30, 2008. The decrease in the 2008 periods is due to the write-off of fees associated with the portion of long-term debt repurchased in 2008.

⁵ In the first quarter of 2008, we recognized an other-than-temporary impairment of \$6.5 million on a publicly-traded equity security, due to the duration of time that the investment had been below cost and the decline in the public stock price during the quarter.

⁶ In the second quarter of 2008, we recognized a gain of \$218,000 on the sale of a non-marketable equity security.

Provision (benefit) for income taxes

The provision (benefit) for income taxes recorded for the third quarter of 2008 and 2007 was \$314,000 and \$775,000, respectively and \$(948,000) and \$1.8 million for the first nine months of 2008 and 2007, respectively. The provision (benefit) includes current and deferred tax expense in profitable cost-plus foreign jurisdictions and accruals for tax contingencies in foreign jurisdictions. Additionally, during the first quarter of 2008, we recorded a benefit of \$1.0 million for refundable research and experimentation

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

Business Outlook

On October 23, 2008, we provided an outlook for the fourth quarter of 2008 in our earnings release, which was furnished on a current report on Form 8-K. The outlook provided the following anticipated financial results prepared in accordance with U.S. generally accepted accounting principles:

We expect to record net loss per share in the fourth quarter of 2008 of \$(0.13) to \$(0.32), based on the following estimates:

- Fourth quarter revenue of \$18.5 million to \$20.5 million.
- Gross profit margin of approximately 45% to 48%.
- Operating expenses of \$11.0 million to \$12.0 million.
- Nominal interest and other income, net.
- Tax provision of approximately \$750,000.

Liquidity and Capital Resources

Cash and short- and long-term marketable securities

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

	September 30, 2008	December 31, 2007	\$ change	% change
Cash and cash equivalents	\$ 42,780	\$ 74,572	\$(31,792)	(43)%
Short-term marketable securities	18,560	34,581	(16,021)	(46)
Long-term marketable securities	1,490	9,804	(8,314)	(85)
Total cash and marketable securities	<u>\$ 62,830</u>	<u>\$ 118,957</u>	<u>\$(56,127)</u>	(47)%

Total cash and marketable securities decreased 47% during the first nine months of 2008. The decrease resulted primarily from \$58.6 million for the repurchase of long-term debt, \$3.9 million in payments on property and equipment and other asset financing, \$2.1 million for the repurchase of our common stock and \$1.5 million for purchases of property and equipment and other long-term assets. The decreases were partially offset by \$13.2 million positive cash flow from operations.

We anticipate that our existing cash and investment balances will be adequate to fund our operating and investing needs for the next twelve months and the foreseeable future. From time to time, we may evaluate acquisitions of businesses, products or technologies that complement our business. We also may repurchase additional amounts of our long-term debt or repurchase shares of our common stock, as authorized under our share repurchase program. 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.

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Accounts receivable, net

Accounts receivable, net decreased to \$5.9 million at September 30, 2008 from \$6.2 million at December 31, 2007. The average number of days sales outstanding increased to 25 days at September 30, 2008 from 21 days at December 31, 2007.

Inventories, net

Inventories, net decreased to \$5.3 million at September 30, 2008 from \$11.3 million at December 31, 2007. Inventory turnover on an annualized basis increased to 6.5 at September 30, 2008 from 3.9 at December 31, 2007. As of September 30, 2008, this represented approximately eight weeks of inventory on hand.

Capital resources

In 2004, we issued \$150.0 million of 1.75% convertible subordinated debentures (the “debentures”) due 2024. In February 2006, we repurchased and retired \$10.0 million of the debentures. In February 2008, we repurchased and retired \$50.2 million principal amount of the debentures through a modified dutch auction tender offer for \$37.9 million in cash. We recognized a net gain of \$11.6 million on the repurchase, which included a \$13.1 million discount, offset by legal and professional fees of \$755,000 and a write-off of debt issuance costs of \$752,000. In August 2008, we repurchased and retired \$29.2 million of the debentures for \$20.6 million in cash. We recognized a net gain of \$8.1 million on the repurchase, which included an \$8.5 million discount, offset by a write-off of debt issuance costs of \$390,000.

We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the \$60.6 million debentures outstanding at each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019, at a purchase price equal to 100% of the principal amount plus accrued and unpaid interest. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

In September 2007, the Board of Directors authorized the repurchase of up to \$10.0 million of our common stock over the next twelve months. In August 2008, the Board of Directors approved an extension to the program for an additional twelve months, through September 2009. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion. Share repurchases under the program may be made through open market and privately negotiated transactions at our discretion, subject to market conditions and other factors. During 2007, we repurchased 1,260,833 common shares at a cost of \$4.3 million. During the first nine months of 2008, we repurchased 1,031,437 shares for \$2.0 million. As of September 30, 2008, \$3.7 million remained available for repurchase under the plan. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

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Contractual Payment Obligations

A summary of our contractual obligations as of September 30, 2008 is as follows:

Contractual Obligation	Payments Due By Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt ¹	\$ 60,634	\$ —	\$ 60,634	\$ —	\$ —
Interest on long-term debt	3,183	1,061	2,122	—	—
Operating leases ²	6,739	2,198	2,667	1,850	24
Payments on accrued balances related to asset purchases	920	428	492	—	—
Estimated Q4 2008 purchase commitments to contract manufacturers	7,308	7,308	—	—	—
Other purchase obligations and commitments	1,750	1,000	750	—	—
Total ³	\$ 80,534	\$ 11,995	\$ 66,665	\$ 1,850	\$ 24

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

² The operating lease payments above are net of sublease rental income of \$542,000, \$276,000, \$57,000 and \$5,000 expected for the 12 month periods ending September 30, 2009, 2010, 2011 and 2012, respectively.

³ We are unable to reliably estimate the timing of future payments related to uncertain tax positions; therefore, \$10.9 million of income taxes payable has been excluded from the table above.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

As of September 30, 2008, we had convertible subordinated debentures of \$60.6 million outstanding with a fixed interest rate of 1.75%. Interest rate changes affect the fair value of the debentures, but do not affect our earnings or cash flow.

All of our sales are denominated in U.S. dollars and as a result, we have relatively little exposure to foreign currency exchange risk with respect to our sales. We have employees located in offices in the

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People's Republic of China, Taiwan and Japan and as such, a portion of our operating expenses are denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. We do not currently hedge against foreign currency rate fluctuations.

Item 4. Controls and Procedures.

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(d) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting which were identified in connection with management's evaluation required by Rules 13a-15(d) and 15d-15(d) under the Exchange Act, that occurred during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1A. Risk Factors.

Investing in our shares of common stock involves a high degree of risk, and investors should carefully consider the risks described below before making an investment decision. If any of the following risks occur, the market price of our shares of common stock could decline and investors could lose all or part of their investment. Additional risks that we currently believe are immaterial may also impair our business operations. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2007, including our consolidated financial statements and related notes, and our other filings made from time to time with the Securities and Exchange Commission.

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

On June 4, 2008, we effected a one-for-three reverse split of our common stock. We effected the reverse split to attempt to regain compliance with NASDAQ Marketplace Rules, particularly the minimum \$1.00 per share requirement for continued inclusion on the NASDAQ Global Market. Though the per share price of our common stock increased to over \$2.00 per share immediately following the reverse split, the price has since closed below \$1.00 per share and we cannot guarantee that it will remain at or above \$1.00

per share. If the price again drops below \$1.00 per share, the stock could become subject to delisting again, and we may seek shareholder approval for an additional reverse split. Although NASDAQ has implemented a temporary suspension of the \$1.00 minimum bid price requirement, this requirement is scheduled for reinstatement on January 19, 2009.

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

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

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

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

As widely reported, financial markets in the United States, Europe and Asia have been experiencing extreme disruption in recent months, including, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades of certain investments and declining valuations of others. Governments have taken unprecedented actions intended to address extreme market conditions that include severely restricted credit and declines in real estate values. While we do not currently require access to credit markets to finance our operations, these economic developments affect businesses in a number of ways. The current tightening of credit in financial markets adversely affects the

ability of our customers and suppliers to obtain financing for significant purchases and operations and could result in a decrease in or cancellation of orders for our products or reduced ability to finance operations to supply products to us. We are unable to predict the likely duration and severity of the current disruption in financial markets and adverse economic conditions in the U.S. and other countries. As a result of the worldwide economic slowdown, it is extremely difficult for us and our customers to forecast future sales levels based on historical information and trends. Portions of our expenses are fixed and other expenses are tied to expected levels of sales activities. To the extent that we do not achieve our anticipated level of sales, our gross profit and net income could be adversely affected until such expenses are reduced to an appropriate level.

Fluctuations in our operating results may also be the result of:

- economic conditions specific to the projector, advanced display and semiconductor markets;
- the loss of one or more of our key distributors or customers;
- the deferral of customer orders in anticipation of new products or product enhancements from us or our competitors;
- the announcement or introduction of products and technologies by our competitors;
- changes in the available production capacity at the semiconductor fabrication foundries that manufacture our products and our ability to provide adequate supplies of our products to customers; and
- changes in the costs of manufacturing.

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

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

We have designed our new strategy to help us take advantage of expected market trends. While we have secured design wins with our new products, our expectations may not be accurate and these markets may not develop or they may take longer to develop than we expect. We cannot assure you that the products we are developing to address our new strategy will adequately address the needs of our target customers or that our customers or potential customers will accept our products quickly enough or in sufficient volume to grow revenue and gross profit. A lack of market acceptance or insufficient market acceptance would materially and adversely affect our results of operations.

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

Our future success depends on developers of advanced display products designing our products into their systems. To achieve design wins, we must define and deliver cost-effective, innovative and integrated semiconductors. Once a supplier's products have been designed into a system, the developer may be reluctant to change its source of components due to the significant costs associated with qualifying a new supplier. Accordingly, it may be difficult for us to achieve additional design wins. The failure on our part to obtain additional design wins with leading branded manufacturers or integrators, and to successfully design, develop and introduce new products and product enhancements could seriously limit our ability to grow.

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

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

As of September 30, 2008, \$60.6 million of our 1.75% convertible subordinated debentures due 2024 were outstanding. Although the debt obligations are due in 2024, the holders of debentures have the right to require us to purchase all or a portion of the \$60.6 million outstanding debentures at each of the following dates: May 15, 2011, May 15, 2014 and May 15, 2019. Since the market price of our common stock is significantly below the conversion price of the debentures, the holders of our outstanding debentures are unlikely to convert the debentures into common stock in accordance with the existing terms of the debentures. Accordingly, we expect holders of the debentures to require us to purchase all of the outstanding debentures on May 15, 2011, the earliest date allowed. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, some of which are beyond our control. Additionally, due to recent turmoil in the credit markets and the continued decline in the economy, we may not be able to refinance the debentures at terms that are as favorable as those from which we previously benefited, or at terms that are acceptable to us at all. These debentures could materially and adversely affect our ability to obtain additional debt or equity financing for working capital, acquisitions or other purposes, limit our flexibility in planning for or reacting to changes in our business, reduce funds available for use in our operations and make us more vulnerable to industry downturns and competitive pressures.

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

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

The markets in which we compete or seek to compete are subject to rapid technological change, frequent new product introductions, changing customer requirements for new products and features and evolving industry standards. The introduction of new technologies and emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Examples of changing industry standards include the growing use of broadband to deliver video content, the transition from 720 High Definition to 1080P Full High Definition resolution video, faster screen refresh rates, the proliferation of new display devices and the drive to network display devices together. Our failure to adequately respond to such technological changes could render our products obsolete or significantly decrease our revenue.

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

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

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

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

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

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

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Because the development of our products incorporates not only our complex and evolving technology but also our customers' specific requirements, a lengthy sales process is often required before potential customers begin the technical evaluation of our products. Our customers typically perform numerous tests and extensively evaluate our products before incorporating them into their systems. The time required for testing, evaluation and design of our products into a customer's system can take up to nine months or more. It can take an additional nine months or longer before a customer commences volume shipments of systems that incorporate our products. We cannot assure you that the time required for the testing, evaluation and design of our products by our customers would not be significantly longer than nine months.

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

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

The year ended December 31, 2004 was our first and only year of profitability since inception. Since then, we have incurred annual net losses. In addition, the profitability we achieved during the first and third quarters of 2008 were primarily the result of gains we recognized on the repurchase of a portion of our convertible subordinated debentures. In 2006, we initiated restructuring plans, which we implemented throughout 2007 and the first nine months of 2008, aimed at returning the Company to profitability. We cannot be certain that these plans will be successful or that future restructuring efforts will not be necessary. We may not achieve profitability in the future and, if we do, we may not be able to sustain or increase profitability on a quarterly or annual basis. If we are not profitable in the future, we may be unable to continue our operations.

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

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

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

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

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

The display manufacturing market is highly concentrated and we are, and will continue to be, dependent on a limited number of customers and distributors for a substantial portion of our revenue. Sales to distributors represented 54%, 57% and 52% of revenue for the first nine months of 2008 and the years ended December 31, 2007 and 2006, respectively. Sales to Tokyo Electron Device, or TED, our Japanese distributor, represented 35%, 33% and 26% of revenue for the first nine months of 2008 and years ended December 31, 2007 and 2006, respectively. Revenue attributable to our top five end customers represented 55%, 47% and 39% of revenue for the first nine months of 2008 and years ended December 31, 2007 and 2006, respectively. Sales to Seiko Epson Corporation, our top end customer, represented 22%, 21% and 15% of revenue for the first nine months of 2008 and years ended December 31, 2007 and 2006, respectively. A reduction, delay or cancellation of orders from one or more of our significant customers, or a decision by one or more of our significant customers to select products manufactured by a competitor or to use its own internally-developed semiconductors, would significantly impact our revenue. For example, our loss of a key OEM customer in Europe contributed to a \$45.5 million, or 51%, decrease in advanced television revenue from 2005 to 2006.

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

As of September 30, 2008 and December 31, 2007, we had three and two customers, respectively, that each represented 10% or more of accounts receivable. The concentration of our accounts receivable with a limited number of customers increases our credit risk. The failure of these customers to pay their balances, or any other customer to pay future outstanding balances, would result in an operating expense and reduce our cash flows.

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

Selling to distributors and integrators reduces our ability to forecast sales accurately and increases the complexity of our business. Since our distributors act as intermediaries between us and the companies using our products, we must rely on our distributors to accurately report inventory levels and production forecasts. We must similarly rely on our integrators. Our integrators are original equipment manufacturers (“OEMs”) that build display devices based on specifications provided by branded suppliers. Selling to distributors and OEMs adds another layer between us and the ultimate source of demand for our products, the consumer. These arrangements require us to manage a complex supply chain and to monitor the financial condition and creditworthiness of our distributors, integrators and customers. They also make it more difficult for us to predict demand for our products. Our failure to manage one or more of these challenges could result in

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

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

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

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

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

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

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

A substantial, and potentially increasing, portion of our products are manufactured by foundries located in the PRC. In addition, a significant percentage of our employees are located in this area. Disruptions from natural disasters, health epidemics (including new outbreaks of SARS or bird flu) and political, social and

economic instability may affect the region and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to state plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot be assured that the PRC's policies for economic reforms will be consistent or effective. Our results of operations and financial position may be harmed by changes in the PRC's political, economic or social conditions.

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

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

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

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

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

Our ability to compete effectively with other companies will depend, in part, on our ability to maintain the proprietary nature of our technology, including our semiconductor designs and software. We provide the computer programming code for our software to customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to help protect our proprietary technologies. As of September 30, 2008 we held 88 patents and had 65 patent applications pending for protection of our significant technologies. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources than we do, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our

products, or they may develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries.

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

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

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

- stop selling products using technology that contains the allegedly infringing IP;
- attempt to obtain a license to the relevant IP, which may not be available on reasonable terms or at all;
- attempt to redesign those products that contain the allegedly infringing IP; or
- pay damages for past infringement claims that are determined to be valid or which are arrived at in settlement of such litigation or threatened litigation.

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

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

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

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

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

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

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

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

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

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

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

Semiconductor manufacturing technologies change rapidly and manufacturers typically discontinue older manufacturing processes in favor of newer ones. For instance, a portion of our products use embedded dynamic random access memory, ("DRAM") technology, which requires manufacturing processes that are being phased out. We also utilize 0.18um, 0.15um and 0.13um standard logic processes, which may only be available for the next five to seven years. Once a manufacturer makes the decision to retire a manufacturing process, notice is generally given to its customers. Customers will then either retire the affected part or develop a new version of the part that can be manufactured with a newer process. In the event that a

manufacturing process is discontinued, our current suppliers may be unwilling or unable to manufacture our current products. Additionally, migrating to a new, more advanced process requires significant expenditures for research and development and takes significant time. For example in the third quarter of 2006, one of our third-party foundries discontinued the manufacturing process used to produce one of our products. While we were able to place last time buy orders, we underestimated demand for this part. As a result, we had to pay additional amounts to the foundry to restart production and we were unable to fulfill customer orders in a timely manner. We cannot assure you that we will be able to place last time buy orders in the future or that we will find alternate manufacturers of our products.

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

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

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

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

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

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

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

We are building most of our products on a customer owned tooling basis, also known in the semiconductor industry as COT, where we directly contract the manufacture of wafers and assume the responsibility for the

assembly and testing of our products. As a result, we are subject to increased risks arising from wafer manufacturing yields and risks associated with coordination of the manufacturing, assembly and testing process. Poor product yields result in higher product costs, which could make our products uncompetitive if we increased our prices or could result in low gross profit margins if we did not increase our prices.

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

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

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

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

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

The integration of software with our products adds complexity, may extend our internal development programs and could impact our customers' development schedules. This complexity requires increased coordination between hardware and software development schedules and may increase our operating expenses without a corresponding increase in product revenue. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

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

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

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

We have historically used stock options and other forms of share-based payment awards as key components of our total compensation program in order to retain employees, officers and directors and to provide competitive compensation and benefit packages. In accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, ("SFAS 123R"), we began recording stock-based compensation expense for share-based awards in the first quarter of 2006. As a

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result, we have incurred and will continue to incur significant compensation costs associated with our share-based programs, making it more expensive for us to grant share-based payment awards to employees, officers and directors. To the extent that SFAS 123R makes it more expensive to grant stock options or to continue to have an employee stock purchase plan, we may decide to incur cash compensation costs in the future. Actions that we take to reduce stock-based compensation expense that might be more aggressive than actions implemented by our competitors could make it difficult to attract, retain and motivate employees, officers, or directors, which could adversely affect our competitive position as well as our business and results of operations. As a result of reviewing our equity compensation strategy, in 2006 we reduced the total number of options granted to employees and the number of employees who receive share-based payment awards.

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

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

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

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

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

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

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

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

- potential loss of key employees, particularly those of the acquired organizations.

Our acquisition of Equator has not been as successful as we anticipated. We acquired Equator for an aggregate purchase price of \$118.1 million and recorded, among other assets, \$57.5 million in goodwill, \$36.8 million in acquired developed technology and \$4.2 million in other acquired intangible assets.

However, the Equator technology has not proven as useful as we had hoped, and thus we have recorded impairment losses on goodwill and intangible assets acquired from Equator. Only \$3.9 million of the developed technology acquired from Equator remains on our consolidated balance sheet as of September 30, 2008 and only a few of the Equator employees remain employed by us. Additionally, while we are continuing to provide customers with existing products, we are no longer pursuing stand-alone advanced media processor markets that are not core to our business.

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

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

Risks Related to Our Industry

Insufficient supplies of advanced display components or failure of consumer demand for advanced displays and other digital display technologies to increase would impede our growth and adversely affect our business.

Our product development strategies anticipate that consumer demand for projectors, advanced televisions and other emerging display technologies will increase in the future. The success of our products is dependent on increased demand for these display technologies. The potential size of the market for products incorporating these display technologies and the timing the market’s development are uncertain and will

depend upon a number of factors, all of which are beyond our control. In order for the market in which we participate to grow, advanced display products must be widely available and affordable to consumers.

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 displays continues to fall, we may be required to offer our products to manufacturers at discounted prices due to increased price competition. At the same time, new alternative technologies and industry standards may emerge that directly compete with technologies we offer. We may be required to increase our investment in research and development at the same time that product prices are falling. In addition, even after making this investment, we cannot assure you that our technologies will be superior to those of our competitors or that our products will achieve market acceptance, whether for performance or price reasons. Failure to effectively respond to these trends could reduce the demand for our products.

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

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

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

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

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

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

Other Risks

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

On June 4, 2008, we effected a one-for-three reverse split of our common stock. We effected the reverse split to attempt to regain compliance with NASDAQ Marketplace Rules, particularly the minimum \$1.00 per share requirement for continued inclusion on the NASDAQ Global Market. Though the per share price of our common stock increased to over \$2.00 per share immediately following the reverse split, the price has since closed below \$1.00 per share and we cannot guarantee that it will remain at or above \$1.00 per share. If the price again drops below \$1.00 per share, the stock could become subject to delisting again, and we may seek shareholder approval for an additional reverse split. Although NASDAQ has implemented a temporary suspension of the \$1.00 minimum bid price requirement, this requirement is scheduled for reinstatement on January 19, 2009. Even if the per share price of our common stock remains above \$1.00, 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, but not limited to:

- actual or anticipated fluctuations in our operating results;
- changes in expectations as to our future financial performance;
- changes in financial estimates of securities analysts;
- announcements by us or our competitors of technological innovations, design wins, contracts, standards or acquisitions;
- the operating and stock price performance of other comparable companies;
- announcements of future expectations by our customers;
- changes in market valuations of other technology companies; and
- inconsistent trading volume levels of our common stock.

The stock prices of technology companies similar to Pixelworks have been highly volatile. Market fluctuations, particularly over the past several months, as well as general economic and political conditions, including recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our common stock. Therefore, the price of our common stock may decline, and the value of your investment may be reduced regardless of our performance. Any scenario in which investors may not be able to realize a gain when they sell our common stock would have an adverse effect on our business, financial condition and results of operations, by potentially limiting our ability to attract and retain qualified employees and to raise capital.

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

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

- our board of directors is authorized, without prior shareholder approval, to change the size of the board. Our articles of incorporation provide that if the board is increased to eight or more members, the board will be divided into three classes serving staggered terms, which would make it more difficult for a group of shareholders to quickly change the composition of our board;
- our board of directors is authorized, without prior shareholder approval, to create and issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us or to effect a change of control, commonly referred to as “blank check” preferred stock;
- members of our board of directors can only be removed for cause and at a meeting of shareholders called expressly for that purpose, by the vote of 75 percent of the votes then entitled to be cast for the election of directors;
- the board of directors may alter our bylaws without obtaining shareholder approval; and
- shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting.

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

As of September 30, 2008, we had \$60.6 million of unsecured convertible debentures due 2024 outstanding. Although the obligations are due in 2024, the holders of debentures have the right to require us to purchase all or a portion of the \$60.6 million debentures outstanding as of each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019. Since the market price of our common stock is significantly below the conversion price of the debentures, the holders of our outstanding debentures are unlikely to convert the debentures to common stock in accordance with the existing terms of the debentures. Accordingly, we expect holders of the debentures to require us to purchase all of the outstanding debentures on May 15, 2011. The purchase of our outstanding debentures at face value would require the use of substantially all of our cash and marketable securities.

On September 25, 2007, we announced a share repurchase program under which the board of directors authorized the repurchase of up to \$10.0 million of our common stock over the following twelve months. During 2007, we repurchased 1,260,833 common shares at a cost of \$4.3 million. During the first nine months of 2008 we repurchased 1,031,437 shares for \$2.0 million. As of September 30, 2008, \$3.7 million remained available for repurchase under the plan.

While we believe that our current cash and marketable securities balances will be sufficient to meet our capital requirements for the next twelve months, we cannot assure you that we will be able to maintain sufficient cash and marketable security balances to refinance or service the potential exercise of the put option on the convertible debentures. We may need, or could elect to seek, additional funding prior to that time through public or private equity or debt financing. Additional funds may not be available on terms favorable to us or our shareholders. Furthermore, 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.

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

We are spending a significant amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission rules and regulations and NASDAQ Global Market rules. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management's annual review and evaluation of internal control over financial reporting. While we invested significant time and money in our effort to evaluate and test our internal control over financial reporting, a material weakness was identified in our internal control over financial reporting in 2004. Although the material weakness was remediated in the first quarter of 2005, there are inherent limitations to the effectiveness of any system of internal controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective controls and procedures can provide only reasonable assurance of achieving their control objectives.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

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

Period	Total number of shares purchased ⁽¹⁾	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
July 1, 2008 - July 31, 2008	9,600	\$ 1.62	9,600	\$ 4,345
August 1, 2007 - August 31, 2008	226,500	1.76	226,500	3,946
September 1, 2008 - September 30, 2008	187,600	1.43	187,600	3,678
Total	<u>423,700</u>	\$ 1.61	<u>423,700</u>	

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

Item 6. Exhibits.

10.1	Summary of Pixelworks Non-Employee Director Compensation.+
10.2	Amendment to Office Lease dated October 2, 2007 and commencing November 1, 2007 by and between Pixelworks, Inc. and Union Bank of California as Trustee for Quest Group Trust IV.
10.3	Office Lease Agreement dated September 10, 2008 and commencing December 1, 2008 by and between Pixelworks, Inc. and Durham Plaza, LLC.
21	Subsidiaries of Pixelworks, Inc.
31.1	Certification of Chief Executive Officer.
31.2	Certification of Chief Financial Officer.
32.1*	Certification of Chief Executive Officer.
32.2*	Certification of Chief Financial Officer.

+ Indicates a management contract or compensation arrangement.

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

SIGNATURE

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

PIXELWORKS, INC.

Dated: November 7, 2008

/s/ Steven L. Moore

Steven L. Moore
*Vice President, Chief Financial
Officer, Secretary and Treasurer*

Summary of Pixelworks Non-Employee Director Compensation

Annual compensation will be paid in quarterly increments, and the following rates will apply from the third quarter of 2008:

Cash compensation:

<i>Board Member Retainer</i>	\$27,000 per year
<i>Audit Committee Retainer</i>	\$8,000 per year, regular member \$16,000 per year, Chair
<i>Compensation Committee Retainer</i>	\$5,000 per year, regular member \$10,000 per year, Chair
<i>Nominating and Governance Committee Retainer</i>	\$3,000 per year, regular member \$6,000 per year, Chair

Stock Compensation Plan:

6,000 shares per year (measured from annual meeting to annual meeting), policy to begin with term in office beginning with the 2009 annual meeting. New non-employee Board members will receive an initial recruitment grant of 10,000 shares.

Other:

Mr. Alley's director compensation is determined by the CEO Transition Agreement dated and effective December 12, 2006, by and between Allen Alley and Pixelworks, Inc. (Exhibit 10.10 to the Company's Annual Report on Form 10-K filed on March 12, 2007).

SECOND AMENDMENT TO LEASE

Amendment date: August 8, 2008
Lease date: June 20, 2005

Tenant: Pixelworks Inc.
Landlord: Union Bank of California, as Trustee for Quest Group Trust
 VI

Premises: 8100 SW Nyberg Road Suites 100-400 Tualatin, Oregon
 97062

All terms, conditions, and covenants of the original lease and any addendums, exhibits, and/or attachments to the original lease referenced above shall remain the same, in full force and effect during the occupancy of tenant, with the addition of the following:

1. **Diminished Premises:** As of October 1, 2008, Tenant's premises shall decrease from 54,683 square feet to 49,472 square feet. The diminished premises shall include Suites 100, 105, 107, 111, 201, 300 and 400 Tualatin, Oregon 97062.
 2. **Commencement Date:** The term for the diminished premises shall commence on October 1, 2008 and termination shall be February 28, 2009.
 3. **Monthly Base Rent:** The following chart reflects the amended monthly base rent for the balance of the lease term:

October 1, 2008- January 31, 2009:	\$102,366
February 1, 2009- February 28, 2009:	\$102,861
 4. **Operating Expenses:** Commencing on October 1, 2008, the Tenant's Proportion Share per Section 19 of the Lease Agreement shall be decreased from 97.96% to 88.61%. Tenant's base year shall remain 2006.
 5. **Security Deposit:** Landlord is holding \$115,772 and no additional security deposit shall be due.
 6. **Lease commission:** There is no lease commission for this transaction.
 7. **Contingency:** This proposal is contingent upon Landlord executing a lease agreement with West Yost Associates.
-

As amended by this Second Amendment to Lease, the Lease shall remain in full force and effect, including all items in the Second Amendment to Lease now signed. All other terms of the original lease remain the same.

IN WITNESS WHEREOF, the parties hereto have executed this Lease Amendment.

Landlord:

Union Bank of California as
As Trustee for Quest Group VI

By: /s/ Jason Kaufman
Jason Kaufman

Title: Assistant Vice President

Date: 8/20/08

Tenant:

Pixelworks Inc.

By: /s/ Steven Moore
Steven Moore

Title: Chief Financial Officer

Date: 9/4/2008

Standard Form of OFFICE LEASE
© 2004 PORTLAND METROPOLITAN ASSOCIATION OF BUILDING OWNERS AND MANAGERS

1.1 Basic Lease Terms.**A. REFERENCE DATE OF LEASE** *September 10, 2008***B. TENANT:** *Pixelworks, Inc.*

Trade Name: _____

Address (Leased Premises): *16760 Upper Boones Ferry Road, Suite 101
Durham, Oregon 97224*Address (For Notices): *Same as above.*

_____**C. LANDLORD:** *Durham Plaza, LLC*Address (For Notices): *c/o NAI Norris, Beggs & Simpson
121 SW Morrison Street, Suite 200
Portland, OR 97004***D. PREMISES:** Suite *101* in the *Durham Plaza Office* Building (the "Building") at *16760 Upper Boones Ferry Road* in *Durham*, Oregon, as generally shown on Exhibit A hereto.**E. PREMISES AREA:** Approximately *4,875* Rentable Square Feet (See Exhibit "A")**F. BUILDING AREA:** Approximately *43,024* Rentable Square Feet**G. TENANT'S PROPORTIONATE SHARE:** *11.33%*. The percentage is obtained by dividing the rentable square feet of the Premises by the total number of rentable square feet of the Building. Landlord may modify Tenant's Proportionate Share if the Building size is increased or decreased, as the case may be.**H. TENANT'S PERMITTED USE OF PREMISES:** *General office use.***I. TERM OF LEASE:** Commencement Date: *Upon substantial completion of Tenant Improvements performed by landlord (which is anticipated to be December 1, 2008). The actual Commencement Date shall be memorialized by a commencement memorandum issued by Landlord during "punch list" completion.*

Expiration Date:	<i>Sixty (60) full calendar months after the Commencement Date.</i>
Number of Full Calendar Months:	<i>Sixty (60)</i>

J. INITIAL BASE MONTHLY RENT: *\$10,562.50 (months 1 through 12).***K. BASE RENT ADJUSTMENT:**

Effective Date of Rent Increase	New Base Monthly Rent
<i>Months 1 — 12</i>	<i>\$10,562.50</i>
<i>Months 13 — 24</i>	<i>\$10,879.38</i>
<i>Months 25 — 36</i>	<i>\$11,205.76</i>
<i>Months 37 — 48</i>	<i>\$11,541.93</i>
<i>Months 49 — 60</i>	<i>\$11,888.19</i>

_____
Landlord_____
Tenant
JAM/kmm

L. BASE YEAR: REAL PROPERTY TAXES 2008 — 2009 EXPENSES 2009

M. PARKING: 19 Spaces [Insert "NA" if not applicable]

N. PREPAID RENT: Upon execution of this Lease, Tenant shall deposit with Landlord \$10,562.50 (the "Prepaid Rent") which shall be Base Monthly Rent due for *first month* of the Lease term.

O. SECURITY DEPOSIT: Upon execution of this Lease, Tenant shall deposit with Landlord \$12,244.83 (the "Security Deposit").

P. BROKER(S): *NAI Norris, Beggs & Simpson as Landlord Representative shall be compensated with 2.5% of the total lease consideration for the first five (5) years. Integrated Corporate Property Services (Mark Childs) as Tenant Representative shall be compensated with 5% of the total lease consideration of the first five (5) years of rent. Fees shall be paid by Landlord one half upon invoice following execution of lease, and one half upon invoice following rent commencement.*

Q. GUARANTOR(S): N/A

If Guarantor(s) is/are listed, Tenant shall cause all Guarantor(s) to return to Landlord an executed Guaranty of this Lease in the form attached as Exhibit D at the same time as Lease execution.

For valuable consideration, Landlord and Tenant covenant and agree as follows:

1.2 Lease of Premises.

Landlord leases to Tenant the premises described in the Basic Lease Terms and shown on Exhibit A (the "Premises"), located in the Building, subject to the terms and conditions of this Lease.

1.3 Delivery of Possession and Commencement.

Should Landlord be unable to deliver possession of the Premises on the commencement date stated in the Basic Lease Terms, the commencement date will be deferred and Tenant shall owe no rent until notice from Landlord tendering possession to Tenant. If possession is not so tendered within ninety (90) days following the commencement date set forth in the Basic Lease Terms, then Tenant may elect to terminate this Lease by notice to Landlord within ten (10) days following expiration of the ninety (90)-day period. Landlord shall have no liability to Tenant for delay in delivering possession. The expiration date of this Lease shall be the date stated in the Basic Lease Terms or, if later, the last day of the calendar month that is the number of full calendar months stated in the Basic Lease Terms from the month in which the commencement date occurs. The Premises shall be improved in accordance with Exhibit B. The existence of any "punchlist"-type items shall not postpone the commencement date of this Lease. Tenant's occupancy of the Premises shall constitute conclusive acceptance of the amount of square footage stated herein, and of the condition of the Premises.

2.1 Rent Payment.

Tenant shall pay to Landlord the Base Rent for the Premises and any additional rent provided herein, without deduction or offset. At the same time as execution of the Lease, Tenant shall pay the Base Rent for the first full month of the Lease term for which rent is payable. Rent is payable in advance on the first day of each month commencing on the commencement date of this Lease. Rent for any partial month during the Lease term shall be prorated to reflect the number of days during the month that Tenant occupies the Premises. Additional rent means amounts determined under Section 19 of this Lease and any other sums payable by Tenant to Landlord under this Lease. Rent not paid when due shall bear interest at the rate of 1 1/2 percent per month, or if less the maximum applicable rate of interest permitted by law, until paid. Landlord may at its option impose a late charge of the greater of \$.05 for each \$1 of rent or \$50 for rent payments made more than ten (10) days late in lieu of interest for the first month of delinquency. Tenant acknowledges that late payment by Tenant to Landlord of any rent or other sums due under this Lease will cause Landlord to incur costs not contemplated by this Lease, the exact amount of such costs being

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extremely difficult and impracticable to ascertain, and that such late charge represents a fair and reasonable estimate of the costs that Landlord will incur by reason of any such late payment and is not a penalty. Neither imposition nor collection nor failure to impose or collect such late charge shall be considered a waiver of any other remedies available for default. In addition to such late charge, an additional charge of \$75 shall be recoverable by Landlord for any returned checks.

2.2 Prepaid Rent.

Upon the execution of this Lease, Tenant shall pay to Landlord the prepaid rent set forth in the Basic Lease Terms. Landlord's obligations with respect to the prepaid rent are those of a debtor and not of a trustee, and Landlord can commingle the prepaid rent with Landlord's general funds. Landlord shall not be required to pay Tenant interest on the prepaid rent. Landlord shall be entitled to immediately endorse and cash Tenant's prepaid rent; however, such endorsement and cashing shall not constitute Landlord's acceptance of this Lease. In the event Landlord does not accept this Lease, Landlord shall promptly return said prepaid rent to Tenant

3.1 Security Deposit.

At the same time as execution of the Lease by Tenant, Tenant shall pay to Landlord the amount stated in the Basic Lease Terms as a Security Deposit. Landlord may apply the Security Deposit to pay the cost of performing any obligation which Tenant fails to perform within the time required by this Lease, but such application by Landlord shall not waive Landlord's other remedies nor be the exclusive remedy for Tenant's default. If the Security Deposit is applied by Landlord, Tenant shall on demand pay the sum necessary to replenish the Security Deposit to its original amount. In no event will Tenant have the right to apply any part of the Security Deposit to any rent or other sums due under this Lease. If Tenant is not in default at the expiration or termination of this Lease, Landlord shall return the entire Security Deposit to Tenant, except for the portion designated in the Basic Lease Terms, if any, which Landlord shall retain as a non-refundable cleaning fee. Landlord's obligations with respect to the Security Deposit are those of a debtor and not of a trustee, and Landlord can commingle the Security Deposit with Landlord's general funds. Landlord shall not be required to pay Tenant interest on the Security Deposit. Landlord shall be entitled to immediately endorse and cash Tenant's Security Deposit; however, such endorsement and cashing shall not constitute Landlord's acceptance of this Lease. In the event Landlord does not accept this Lease, Landlord shall return said Security Deposit. If Landlord sells its interest in the Premises during the term hereof and deposits with or credits to the purchaser the unapplied portion of the Security Deposit, thereupon Landlord shall be discharged from any further liability or responsibility with respect to the Security Deposit.

4.1 Use.

Tenant shall use the Premises as a business for the Tenant's Permitted Use stated in the Basic Lease Terms and for no other purpose without Landlord's written consent. In connection with its use, Tenant shall at its expense promptly comply and cause the Premises to comply with all applicable laws, ordinances, rules, and regulations of any public authority ("Laws") and shall not annoy, obstruct, or interfere with the rights of other tenants of the Building. Tenant shall create no nuisance nor allow any objectionable fumes, noise, light, vibration, radiation, or electromagnetic waves to be emitted from the Premises. If any sound or vibration produced by Tenant's activities is detectable outside of the Premises, Tenant shall provide such insulation as is required to muffle such sound or vibration and render it undetectable at Tenant's cost. Tenant shall not conduct any activities that will increase Landlord's insurance rates for any portion of the Building or that will in any manner degrade or damage the reputation of the Building. Tenant shall pay before delinquency all taxes, assessments, license fees and public charges levied, assessed or imposed upon its business operations as well as upon all trade fixtures, leasehold improvements, merchandise and other personal property in or about the Premises.

4.2 Equipment.

Tenant shall install in the Premises only such equipment as is customary for Tenant's Permitted Use and shall not overload the floors or electrical circuits of the Premises or Building or alter the plumbing or

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wiring of the Premises or Building. Landlord must approve in advance the location of and manner of installing any wiring or electrical, heat generating, climate sensitive, or communication equipment or exceptionally heavy articles. All telecommunications equipment, conduit, cables and wiring, additional dedicated circuits, and any additional air conditioning required because of heat generating equipment or special lighting installed by Tenant shall be installed and operated at Tenant's expense and, at Landlord's written request shall be removed by Tenant at Tenant's sole cost and expense. Landlord shall have no obligation to permit the installation of equipment by any telecommunications provider whose equipment is not then servicing the Building. Tenant shall have no right to install any equipment on or through the roof of the Building, or use or install or store any equipment or other items outside of the interior boundary of the Premises.

4.3 Signs and Other Installations.

No signs, awnings, or other apparatus shall be painted on or attached to the Building or anything placed on any glass or woodwork of the Premises or positioned so as to be visible from outside the Premises, including any window covering (e.g., shades, blinds, curtains, drapes, screens, or tinting materials) without Landlord's written consent, and Landlord's approval as to design, size, location, and color. All signs installed by Tenant shall comply with Landlord's standards for signs and all applicable codes and all signs and sign hardware shall be removed upon termination of this Lease with the sign location restored to its former state unless Landlord elects to retain all or any portion thereof. Tenant may not install any alarm boxes, foil protection tape, or other security equipment on the Premises without Landlord's prior written consent. Any material violating this provision may be removed and disposed by Landlord without compensation to Tenant, and Tenant shall reimburse Landlord for the cost of the same upon request.

4.4 Parking.

If a number of parking spaces is designated in the Basic Lease Terms, then during the term of this Lease, Landlord shall make available to Tenant's employees such number of parking space(s) at the parking lot servicing the Building. Landlord's obligation pursuant to this Section shall be limited to making such spaces available in whatever manner Landlord deems appropriate (attended, unattended, marked stalls, or other means), as long as the number of spaces referred to are made available to Tenant. ~~Tenant shall be required to pay as rental for the spaces made available to, and used by, Tenant the established parking rates for the Building or lot (as the case may be), as adjusted from time to time, and such sum shall be additional rent payable under this Lease.~~

5.1 Utilities and Services.

Landlord will furnish water and electricity to the Building at all times and will furnish heat and air conditioning (if the Building is air conditioned), at building standard levels, during the normal Building hours as established by Landlord. Janitorial service will be provided in accordance with the regular schedule of the Building, which schedule and service may change from time to time. Tenant shall comply with all government laws or regulations regarding the use or reduction of use of utilities on the Premises. Interruption of services or utilities shall not be deemed an eviction or disturbance of Tenant's use and possession of the Premises, render Landlord liable to Tenant for damages, or relieve Tenant from performance of Tenant's obligations under this Lease. Landlord shall take all reasonable steps to correct any interruptions in service caused by defects in utility systems within Landlord's reasonable control. Electrical service furnished will be 110 volts unless different service already exists in the Premises. Tenant shall provide its own surge protection for power furnished to the Premises. Landlord shall have the exclusive right to choose the utility service providers to the Premises and may change providers at its discretion. Tenant shall cooperate with Landlord and the utility service providers at all times as reasonably necessary, and shall allow Landlord and utility service providers, reasonable access to the pipes, lines, feeders, risers, wiring, and any other machinery within the Premises. Tenant shall not contract or engage any other utility provider without prior written approval of Landlord, which approval Landlord may withhold or condition in Landlord's discretion.

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5.2 Extra Usage.

If Tenant uses excessive amounts of utilities or services of any kind because of operation outside of normal Building hours, high demands from office machinery and equipment, nonstandard lighting, or any other cause, Landlord may impose a reasonable charge for supplying such extra utilities or services, which charge shall be payable monthly by Tenant in conjunction with rent payments. In case of dispute over any extra charge under this Section, Landlord shall designate a qualified independent engineer whose decision shall be conclusive on both parties. Landlord and Tenant shall each pay one-half of the cost of such determination. Landlord reserves the right to install separate meters for any such utility and to charge Tenant for the cost of such installation.

5.3 Security.

Landlord may but shall have no obligation to provide security service or to adopt security measures regarding the Premises, and Tenant shall cooperate with all reasonable security measures adopted by Landlord. Tenant may install a security system within the Premises with Landlord's written consent which will not be unreasonably withheld. Landlord will be provided with an access code to any security system and shall not have any liability for accidentally setting off Tenant's security system. Landlord may modify the type or amount of security measures or services provided to the Building or the Premises at any time without notice.

6.1 Maintenance and Repair.

- 6.1.1 Landlord shall maintain and repair in good condition the Building structure, roof, exterior walls and doors, exterior windows, and common areas of the Building, and the electrical, mechanical, plumbing, heating and air conditioning systems, facilities and components located in the Building that are used in common by all tenants of the Building (including replacing building standard light bulbs). Tenant shall maintain and repair the Premises in good condition, including, without limitation, maintaining and repairing all walls, floors, and ceilings, all interior doors, partitions, and windows, and all Premises systems, fixtures, and equipment that are not the maintenance responsibility of Landlord, as well as damage caused by Tenant, its agents, employees, contractors, or invitees.
- 6.1.2 Landlord shall have no liability for failure to perform required maintenance and repair unless written notice of such maintenance or repair is given by Tenant and Landlord fails to commence efforts to remedy the problem in a reasonable time and manner. Landlord shall have the right to erect scaffolding and other apparatus necessary for the purpose of making repairs or alterations to the Building, and Landlord shall have no liability for interference with Tenant's use because of such work. Work may be done during normal business hours. Tenant shall have no claim against Landlord for any interruption or reduction of services or interference with Tenant's occupancy caused by Landlord's maintenance and repair, and no such interruption or reduction shall be construed as a constructive or other eviction of Tenant.
- 6.1.3 Landlord's cost of repair and maintenance shall be considered "operating expenses" for purposes of Section 19.3, except that repair of damage caused by negligent or intentional acts or breach of this Lease by Tenant, its contractors, agents, or invitees shall be at Tenant's expense.

6.2 Alterations.

- 6.2.1 **The Tenant will not be responsible for the end of the lease term removal of any improvements presented in Exhibit A and B.** Tenant shall not make any alterations, additions, or improvements to the Premises, change the color of the interior, or install any wall or floor covering without Landlord's prior written consent which may be withheld in Landlord's sole discretion. Should Landlord consent in writing to Tenant's alteration of the Premises, Tenant shall contract with a contractor approved by Landlord for the construction of such alterations, shall secure all appropriate governmental approvals and permits, and shall complete such alterations with due diligence in compliance with the plans and specifications approved by Landlord. All such construction shall be performed in a manner which will not interfere with the quiet enjoyment of other tenants of the Building. Any such improvements, alterations, wiring, cables, or conduit installed by Tenant shall at once become part of the Premises and belong to Landlord except for removable machinery and unattached movable trade fixtures. Landlord may at its option, **if specified at the time of**



approval of the alteration, require that Tenant remove any improvements, alterations, wiring, cables or conduit installed by or for Tenant and restore the Premises to the original condition upon termination of this Lease. Landlord shall have the right to approve the contractor used by Tenant for any work in the Premises, and to post notices of nonresponsibility in connection with work being performed by Tenant in the Premises. Work by Tenant shall comply with all laws then applicable to the Premises. Tenant shall not allow any liens to attach to the Building or Tenant's interest in the Premises as a result of its activities or any alterations.

6.2.2 Landlord may perform alterations to or change the configuration of the Building, the Building, the parking area, and other common areas.

7.1 Indemnity.

Tenant shall indemnify, defend, and hold harmless Landlord and its managing agents and employees from any claim, liability, damage, or loss occurring in, on, or about the Premises, or any cost or expense in connection therewith (including attorney fees), arising out of (a) any damage to any person or property occurring in, on, or about the Premises, (b) use by Tenant or its agents, invitees or contractors of the Premises and/or the Building, and/or (c) Tenant's breach or violation of any term of this Lease.

7.2 Insurance.

Tenant shall carry liability insurance with limits of not less than Two Million Dollars (\$2,000,000) combined single limit bodily injury and property damage which insurance shall have an endorsement naming Landlord and Landlord's managing agent, if any, as an additional insured, cover the liability insured under Section 7.1 of this Lease and be in form and with companies reasonably acceptable to Landlord. Prior to occupancy, Tenant shall furnish a certificate evidencing such insurance which shall state that the coverage shall not be canceled or materially changed without thirty (30) days' advance notice to Landlord and Landlord's managing agent, if any. Tenant shall furnish to Landlord a renewal certificate at least thirty (30) days prior to expiration of any policy.

8.1 Fire or Casualty.

"Major Damage" means damage by fire or other casualty to the Building or the Premises which causes the Premises or any substantial portion of the Building to be unusable, or which will cost more than 25 percent of the pre-damage value of the Building to repair, or which is not covered by insurance. In case of Major Damage, Landlord may elect to terminate this Lease by notice in writing to the Tenant within thirty (30) days after such date. If this Lease is not terminated following Major Damage, or if damage occurs which is not Major Damage, Landlord shall promptly restore the Premises to the condition existing just prior to the damage. Tenant shall promptly restore all damage to tenant improvements or alterations installed or paid for by Tenant or pay the cost of such restoration to Landlord if Landlord elects to do the restoration of such improvements. Unless the casualty was caused by Tenant, rent shall be reduced from the date of damage until the date restoration work being performed by Landlord is substantially complete, with the reduction to be in proportion to the area of the Premises not usable by Tenant.

8.2 Waiver of Subrogation.

Tenant shall be responsible for insuring its personal property and trade fixtures located on the Premises and any alterations or tenant improvements it has made to the Premises. Neither Landlord, its managing agent nor Tenant shall be liable to the other for any loss or damage caused by water damage, sprinkler leakage, or any of the risks that are covered by property insurance or could be covered by a customary broad form of property insurance policy, or for any business interruption, and there shall be no subrogated claim by one party's insurance carrier against the other party arising out of any such loss.

9.1 Eminent Domain.

If a condemning authority takes title by eminent domain or by agreement in lieu thereof to the entire Building or a portion sufficient to render the Premises unsuitable for Tenant's use, then either party may elect to terminate this Lease effective on the date that possession is taken by the condemning authority. If



this Lease is not terminated, then rent shall be reduced for the remainder of the term in an amount proportionate to the reduction in area of the Premises caused by the taking. All condemnation proceeds shall belong to Landlord, and Tenant shall have no claim against Landlord or the condemnation award because of the taking.

10.1 Assignment and Subletting.

Tenant shall not assign or encumber its interest under this Lease or sublet all or any portion of the Premises without first obtaining Landlord's consent in writing. This provision shall apply to all transfers by operation of law, and to all mergers and changes in control of Tenant, all of which shall be deemed assignments for the purposes of this Section. No assignment shall relieve Tenant of its obligation to pay rent or perform other obligations required by this Lease, and no consent to one assignment or subletting shall be a consent to any further assignment or subletting. If Tenant proposes a subletting or assignment for which Landlord's consent is required, Landlord shall have the option of terminating this Lease and dealing directly with the proposed subtenant or assignee, or any third party. If Landlord does not terminate this Lease, Landlord shall not unreasonably withhold its consent to any assignment or subletting provided the effective rental paid by the subtenant or assignee is not less than the current scheduled rental rate of the Building for comparable space and the proposed Tenant is compatible with Landlord's normal standards for the Building. If an assignment or subletting is permitted, any cash net profit, or the net value of any other consideration received by Tenant as a result of such transaction shall be paid to Landlord promptly following its receipt by Tenant. Tenant shall pay any costs incurred by Landlord in connection with a request for assignment or subletting, including reasonable attorney fees.

11.1 Default.

Any of the following shall constitute an Event of Default by Tenant under this Lease (time of performance being of the essence of this Lease):

- 11.1.1 Tenant's failure to pay rent or any other charge under this Lease within ten (10) days after it is due.
- 11.1.2 Tenant's failure to comply with any other term or condition within twenty (20) days following written notice from Landlord specifying the noncompliance. If such noncompliance cannot be cured within the twenty (20)-day period, this provision shall be satisfied if Tenant commences correction within such period and thereafter proceeds in good faith and with reasonable diligence to complete correction as soon as possible but not later than ninety (90) days after the date of Landlord's notice.
- 11.1.3 Failure of Tenant to execute the documents described in Section 16.1 or 16.3 within the time required under such Sections; failure of Tenant to provide or maintain the insurance required of Tenant pursuant hereto; or failure of Tenant to comply with any Laws as required pursuant hereto within twenty-four (24) hours after written demand by Landlord.
- 11.1.4 Tenant's insolvency, business failure, or assignment for the benefit of its creditors. Tenant's commencement of proceedings under any provision of any bankruptcy or insolvency law or failure to obtain dismissal of any petition filed against it under such laws within the time required to answer; or the appointment of a receiver for all or any portion of Tenant's properties or financial records.
- 11.1.5 Assignment or subletting by Tenant in violation of Section 10.1.
- 11.1.6 Vacation or abandonment of the Premises without the written consent of Landlord or failure to occupy the Premises within twenty (20) days after notice from Landlord tendering possession.

11.2 Remedies for Default.

Upon occurrence of an Event of Default as described in Section 11.1, Landlord shall have the right to the following remedies, which are intended to be cumulative and in addition to any other remedies provided under applicable law or under this Lease:

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- 11.2.1 Landlord may at its option terminate this Lease, without prejudice to its right to damages for Tenant's breach. With or without termination, Landlord may retake possession of the Premises and may use or relet the Premises without accepting a surrender or waiving the right to damages. Following such retaking of possession, efforts by Landlord to relet the Premises shall be sufficient if Landlord follows its usual procedures for finding tenants for the space at rates not less than the current rates for other comparable space in the Building. If Landlord has other vacant space in the Building, prospective tenants may be placed in such other space without prejudice to Landlord's claim to damages or loss of rentals from Tenant.
- 11.2.2 Landlord may recover all damages caused by Tenant's default which shall include an amount equal to rentals lost because of the default, Lease commissions paid for this Lease, and the unamortized cost of any tenant improvements installed by or paid for by Landlord. Landlord may sue periodically to recover damages as they occur throughout the Lease term, and no action for accrued damages shall bar a later action for damages subsequently accruing. Landlord may elect in any one action to recover accrued damages plus damages attributable to the remaining term of the Lease. Such damages shall be measured by the difference between the rent under this Lease and the reasonable rental value of the Premises for the remainder of the term, discounted to the time of judgment at the prevailing interest rate on judgments.

11.3 Landlord's Right To Cure Default.

Landlord may, but shall not be obligated to, make any payment or perform any obligation which Tenant has failed to perform when required under this Lease. All of Landlord's expenditures incurred to correct the failure to perform shall be reimbursed by Tenant upon demand with interest from the date of expenditure at the rate of 1 1/2 percent per month. Landlord's right to correct Tenant's failure to perform is for the sole protection of Landlord and the existence of this right shall not release Tenant from the obligation to perform all of the covenants herein required to be performed by Tenant, or deprive Landlord of any other right which Landlord may have by reason of default of this Lease by Tenant, whether or not Landlord exercises its right under this Section.

12.1 Surrender; Holdover.

On expiration or early termination of this Lease, Tenant shall deliver all keys to Landlord and surrender the Premises vacuumed, swept, and free of debris and in the same condition as at the commencement of the term subject only to reasonable wear from ordinary use. Tenant shall remove all of its furnishings and trade fixtures that remain its property and any alterations, cables, or conduits if required by Section 6.2, and shall repair all damage resulting from such removal. Failure to remove shall be an abandonment of the property, and, following ten (10) days' written notice, Landlord may remove or dispose of it in any manner without liability, and recover the cost of removal and other damages from Tenant. If Tenant fails to vacate the Premises when required, including failure to remove all its personal property, Landlord may elect either: (i) to treat Tenant as a tenant from month to month, subject to the provisions of this Lease except that rent shall be one-and-one-half quarter times the total rent being charged when the Lease term expired, and any option or other rights regarding extension of the term or expansion of the Premises shall no longer apply; or (ii) to eject Tenant from the Premises (using self-help or otherwise) and recover damages caused by wrongful holdover.

13.1 Regulations.

Landlord shall have the right but shall not be obligated to make, revise and enforce rules and regulations or policies consistent with this Lease for the purpose of promoting safety, health, order, economy, cleanliness, and good service to all tenants of the Building, including, but not limited to, moving, use of common areas, and prohibition of smoking. All such regulations and policies including those, if any, attached to this Lease, shall be complied with as if part of this Lease and failure to comply shall be a default.

14.1 Access.

During times other than normal Building hours, Tenant's officers and employees or those having business with Tenant may be required to identify themselves or show passes in order to gain access to the Building. Landlord shall have no liability for permitting or refusing to permit access by anyone. Landlord may regulate access to any Building elevators outside of normal Building hours. Landlord shall have the right



to enter upon the Premises at any time by passkey or otherwise to determine Tenant's compliance with this Lease, to perform necessary services, maintenance and repairs or alterations to the Building or the Premises, to post notices of nonresponsibility, or to show the Premises to any prospective tenant or purchasers. Except in case of emergency, such entry shall be at such times and in such manner as to minimize interference with the reasonable business use of the Premises by Tenant.

14.2 Furniture and Bulky Articles.

Tenant shall move furniture and bulky articles in and out of the Building or make independent use of any elevators only at times approved by Landlord following at least 24 hours' written notice to Landlord of the intended move.

15.1 Notices.

Notices between the parties relating to this Lease shall be in writing, effective when delivered during business hours by facsimile transmission, hand delivery, private courier, or first-class or certified U.S. mail. Notices shall be delivered postage prepaid, to the address or facsimile number for the party stated in the Basic Lease Terms or to such other address as either party may specify by notice to the other. Notice to Tenant may always be delivered to the Premises. Rent shall be payable to Landlord at the same address and in the same manner, but shall be considered paid only when received.

16.1 Subordination and Attornment.

This Lease shall be subject to and subordinate to any mortgages, deeds of trust, ground lease, master lease, or land sale contracts (hereafter collectively referred to as encumbrances) now existing against the Building. At Landlord's option this Lease shall be subject and subordinate to any future encumbrance, ground lease, or master lease hereafter placed against the Building (including the underlying land) or any modifications of existing encumbrances, and Tenant shall execute such documents as may reasonably be requested by Landlord or the holder of the encumbrance to evidence this subordination. If any encumbrance is foreclosed, then if the purchaser at foreclosure sale gives to Tenant a written agreement to recognize Tenant's Lease, Tenant shall attorn to such purchaser and this Lease shall continue.

16.2 Transfer of Building.

If the Building is sold or otherwise transferred by Landlord or any successor, Tenant shall attorn to the purchaser or transferee and recognize it as the landlord under this Lease, and, provided the purchaser or transferee assumes all obligations under this Lease thereafter accruing, the transferor shall have no further liability hereunder.

16.3 Estoppels.

Either party will within ten (10) days after notice from the other execute, acknowledge, and deliver to the other party a certificate certifying whether or not this Lease has been modified and is in full force and effect; whether there are any modifications or alleged breaches by the other party; the dates to which rent has been paid in advance, and the amount of any security deposit or prepaid rent; and any other facts that may reasonably be requested. Failure to deliver the certificate within the specified time shall be conclusive upon the party of whom the certificate was requested that the Lease is in full force and effect and has not been modified except as may be represented by the party requesting the certificate. If requested by the holder of any encumbrance, or any underlying lessor, Tenant will agree to give such holder or lessor notice of and an opportunity to cure any default by Landlord under this Lease.

17.1 Attorney Fees.

In any litigation arising out of this Lease, including any bankruptcy proceeding, the prevailing party shall be entitled to recover attorney fees at trial and on any appeal or petition for review. If Landlord incurs attorney fees because of a default by Tenant, Tenant shall pay all such fees whether or not litigation is filed. If Landlord employs a collection agency to recover delinquent charges, Tenant agrees to pay all collection agency and other fees charged to Landlord in addition to rent, late charges, interest, and other sums payable under this Lease.



18.1 Quiet Enjoyment.

Landlord warrants that as long as Tenant complies with all terms of this Lease, it shall be entitled to possession of the Premises free from any eviction or disturbance by Landlord or parties claiming through Landlord.

18.2 Limitation on Liability.

Notwithstanding any provision in this Lease to the contrary, neither Landlord nor its managing agent or employees shall have any liability to Tenant for loss or damages to Tenant's property from any cause, nor arising out of the acts, including criminal acts, of other tenants of the Building or third parties, nor any liability for consequential damages, nor liability for any reason which exceeds the value of its interest in the Building.

19.1 Additional Rent: Tax Adjustment.

Tenant shall pay to Landlord, as additional rent, Tenant's Proportionate Share of real property taxes for the Building and its underlying land. Effective January 1 of each year Landlord shall estimate the amount of real property taxes for the ensuing calendar year. Tenant shall pay each month, at the same time as Base Rent, one twelfth of Landlord's estimate of Tenant's Proportionate Share of real property taxes, provided that Landlord may revise its estimate during any year with reasonable cause and the additional estimate shall be payable as equal additions to rent for the remainder of the calendar year. Following the end of each calendar year, or when actual tax year information becomes available, Landlord shall compute the actual real property taxes and bill Tenant for any deficiency or credit Tenant with any excess collected. Tenant shall pay any such deficiency within thirty (30) days after Landlord's billing, whether or not this Lease shall have expired or terminated at the time of such billing. "Real property taxes" as used herein shall mean all taxes and assessments of any public authority against the Building and the land on which it is located, the cost of contesting any tax and any form of fee or charge imposed on Landlord as a direct consequence of owning or leasing the Premises, including but not limited to, rent taxes, gross receipt taxes, leasing taxes, or any fee or charge wholly or partially in lieu of or in substitution for ad valorem real property taxes or assessments, whether now existing or hereafter enacted. If any portion of the Building is occupied by a tax-exempt tenant so that the Building has a partial tax exemption under ORS 307.112 or a similar statute, then real property taxes shall mean taxes computed as if such partial exemption did not exist. If a separate assessment or identifiable tax increase arises because of improvements to the Premises, then Tenant shall pay 100 percent of such increase.

19.2 Additional Rent: Cost of Living Adjustment.

~~Effective on each anniversary following the Commencement Date of this Lease, the Landlord shall be entitled to recover additional rent which shall be a percentage of Base Rent equal to the percentage increase, if any, in the Consumer Price Index published by the United States Department of Labor, Bureau of Labor Statistics. The percentage increase shall be computed by comparing the schedule entitled "West Urban Region, All Items, 1982—84=100" for the latest available month three months preceding the month in which the Lease term commenced with the same figure for the same month in the years for which the adjustment is computed. All comparisons shall be made using index figures derived from the same base period and in no event shall this provision operate to decrease the monthly rent for the Premises below the monthly Base Rent, plus property tax adjustments and operating expense adjustments as provided in this Lease. If the index cited above is revised or discontinued during the term of this Lease then the index that is designated by the Portland Metropolitan Association of Building Owners and Managers to replace it shall be used.~~

19.3 Additional Rent: Operating Expense Adjustment.

Tenant shall pay as additional rent Tenant's Proportionate Share of the amount by which operating expenses for the Building increase over those experienced by Landlord during the Base Year for expenses stated in the Basic Lease Terms. Effective January 1 of each year Landlord shall estimate the amount by which operating expenses are expected to increase, if any, over those incurred in the base year. Monthly rent for that year shall be increased by one-twelfth of Tenant's share of the estimated increase, provided

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that Landlord may revise its estimate during any year with reasonable cause and the additional estimate shall be payable as equal additions to rent for the remainder of the calendar year. Following the end of each calendar year, Landlord shall compute the actual increase in operating expenses and bill Tenant for any deficiency or credit Tenant with any excess collected. Tenant shall pay any such deficiency within thirty (30) days after Landlord's billing, whether or not this Lease shall have expired or terminated at the time of such billing. As used herein "operating expenses" shall mean all costs of operating, maintaining, and repairing the Building as determined by standard real estate accounting practice, including, but not limited to: all water and sewer charges; the cost of natural gas and electricity provided to the Building; janitorial and cleaning supplies and services; administration costs and management fees; superintendent fees; security services, if any; insurance premiums; licenses, permits for the operation and maintenance of the Building and all of its component elements and mechanical systems; ordinary and emergency repairs and maintenance, and the annual amortized capital improvement cost (amortized over such a period as Landlord may select but not shorter than the period allowed under the Internal Revenue Code and at a current market interest rate) for any capital improvements to the Building required by any governmental authority or those which have a reasonable probability of improving the operating efficiency of the Building. "Operating Expenses" shall also include all assessments under recorded covenants or master plans and/or by owner's associations. If electricity or other energy costs increase between the date of this Lease and last day of the Base Year, (i) Tenant shall pay to Landlord, on a monthly basis as additional rent, its Proportionate Share of such cost increase for the period from the date of such increase until the first estimated payment due under this Section, and (ii) Landlord may adjust the calculation of Base Year operating expenses by using the energy costs in effect on the date of this Lease.

19.4 Disputes.

If Tenant disputes any computation of additional rent or rent adjustment under Sections 19.1 through 19.3 of this Lease, it shall give notice to Landlord not later than thirty (30) days after the notice from Landlord describing the computation in question, but in any event not later than (thirty) 30 days after expiration or earlier termination of this Lease. If Tenant fails to give such a notice, the computation by Landlord shall be binding and conclusive between the parties for the period in question. If Tenant gives a timely notice, the dispute shall be resolved by an independent certified public accountant selected by Landlord whose decision shall be conclusive between the parties. Each party shall pay one-half of the fee for making such determination except that if the adjustment in favor of Tenant does not exceed 10 percent of the escalation amounts for the year in question, Tenant shall pay (i) the entire cost of any such third-party determination; and (ii) Landlord's out-of-pocket costs and reasonable expenses for personnel time in responding to the audit. Nothing herein shall reduce Tenant's obligations to make all payments as required by this Lease. In no event shall Landlord have any liability to Tenant based on its calculation of additional rent or rent adjustments except and only the obligation to cause any correction to be made pursuant to this Section 19.4. Tenant shall maintain as strictly confidential the existence and resolution of any dispute regarding rent charges hereunder.

20.1 Hazardous Materials.

Neither Tenant nor Tenant's agents or employees shall cause or permit any Hazardous Material, as hereinafter defined, to be brought upon, stored, used, generated, released into the environment, or disposed of on, in, under, or about the Premises, except reasonable quantities of cleaning supplies and office supplies necessary to or required as part of Tenant's business that are generated, used, kept, stored, or disposed of in a manner that complies with all laws regulating any such Hazardous Materials and with good business practices. Tenant covenants to remove from the Premises (or the Building, if applicable), upon the expiration or sooner termination of this Lease and at Tenant's sole cost and expense, any and all Hazardous Materials brought upon, stored, used, generated, or released into the environment during the term of this Lease. To the fullest extent permitted by law, Tenant hereby agrees to indemnify, defend, protect, and hold harmless Landlord, Landlord's managing agent and their respective agents and employees, and their respective successors and assigns, from any and all claims, judgments, damages, penalties, fines, costs, liabilities, and losses that arise during or after the term directly or indirectly from the use, storage, disposal, release, or presence of Hazardous Materials on, in, or about

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the Premises which occurs during the term of this Lease. Tenant shall promptly notify Landlord of any release of Hazardous Materials in, on, or about the Premises that Tenant or Tenant's agents or employees become aware of during the Term of this Lease, whether caused by Tenant, Tenant's agents or employees, or any other persons or entities. As used herein, the term "Hazardous Materials" shall mean any hazardous or toxic substance, material, or waste which is or becomes regulated by any local governmental authority, the state of Oregon or the United States Government. The term "Hazardous Materials" shall include, without limitation, any material or substance that is (i) defined as a "hazardous waste," "extremely hazardous waste," "restricted hazardous waste," "hazardous substance," "hazardous material," or "waste" under any federal, state, or local law, (ii) petroleum, and (iii) asbestos. The provisions of this Section 20, including, without limitation, the indemnification provisions set forth herein, shall survive any termination of this Lease.

20.2 Mold.

Tenant shall not allow or permit any conduct or omission at the Premises, or anywhere on Landlord's property, that will promote or allow the production or growth of mold, spores, fungus, or any other similar organism, and shall indemnify and hold Landlord harmless from any claim, demand, cost, and expense (including attorney fees) arising from or caused by Tenant's failure to strictly comply with its obligations under this provision.

21.1 Complete Agreement; No Implied Covenants.

This Lease and the attached Exhibits and Schedules if any, constitute the entire agreement of the parties and supersede all prior written and oral agreements and representations and there are no implied covenants or other agreements between the parties except as expressly set forth in this Lease. Neither Landlord nor Tenant is relying on any representations other than those expressly set forth herein.

21.2 Space Leased AS IS.

Unless otherwise stated in this Lease, the Premises are leased AS IS in the condition now existing with no alterations or other work to be performed by Landlord.

21.3 Captions.

The titles to the Sections of this Lease are descriptive only and are not intended to change or influence the meaning of any Section or to be part of this Lease.

21.4 Nonwaiver.

Failure by Landlord to promptly enforce any regulation, remedy, or right of any kind under this Lease shall not constitute a waiver of the same and such right or remedy may be asserted at any time after Landlord becomes entitled to the benefit thereof notwithstanding delay in enforcement.

21.5 Consent.

Except where otherwise provided in this Lease, either party may withhold its consent for any reason or for no reason whenever that party's consent is required under this Lease.

21.6 Force Majeure.

If performance by Landlord of any portion of this Lease is made impossible by any prevention, delay, or stoppage caused by governmental approvals, war, acts of terrorism, strikes, lockouts, labor disputes, acts of God, inability to obtain services, labor, or materials or reasonable substitutes for those items, governmental actions, civil commotions, fire or other casualty, or other causes beyond the reasonable control of Landlord, performance by Landlord for a period equal to the period of that prevention, delay, or stoppage is excused.

21.7 Commissions.

Each party represents that it has not had dealings with any real estate broker, finder, or other person with respect to this Lease in any manner, except for the broker(s) identified in the Basic Lease Terms. Landlord shall pay a leasing commission in accordance with a separate agreement between Landlord and broker.



21.8 Successors.

This Lease shall bind and inure to the benefit of the parties, their respective heirs, successors, and permitted assigns.

21.9 Financial Reports.

Within fifteen (15) days after Landlord's request, Tenant will furnish Tenant's most recent audited financial statements (including any notes to them) to Landlord, or, if no such audited statements have been prepared, such other financial statements (and notes to them) as may have been prepared by an independent certified public accountant or, failing those, Tenant's internally prepared financial statements. Landlord will not disclose any aspect of Tenant's financial statements except (1) to Landlord's lenders or prospective purchasers of the Building who have executed a sales contract with Landlord, (2) in litigation between Landlord and Tenant, or (3) if required by court order.

21.10 Waiver of Jury Trial.

To the maximum extent permitted by law, Landlord and Tenant each waive right to trial by jury in any litigation arising out of or with respect to this Lease.

21.11 Exhibits.

The following Exhibits are attached hereto and incorporated as a part of this Lease:

Exhibit "A" -	Premises
Exhibit "B" -	Work Agreement
Exhibit "C" -	Rules and Regulations

IN WITNESS WHEREOF, the duly authorized representatives of the parties have executed this Lease as of the day and year first written above.

LANDLORD:

Durham Plaza, LLC
c/o NAI Norris, Beggs & Simpson
121 SW Morrison Street, Suite 200
Portland, OR 97204
(503) 273-0256 fax
(503) 223-7181 phone

By: **/s/ Jerry Powell**

Title: **Managing Member**

TENANT:

By: **/s/ Steven Moore**

Title: **Vice President & Chief Financial Officer**

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Standard Form of OFFICE LEASE
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EXHIBIT "B"
Work Agreement

SECTION 1 IMPROVEMENTS PROVIDED BY LANDLORD.

Unless otherwise agreed by Landlord and Tenant in an addendum to the Lease, Landlord shall provide the following improvements in the Premises ("Landlord's Work") and shall obtain, at Landlord's cost, the permits therefor:

Landlord shall improve the Premises in accordance with Exhibit A, this Exhibit B, and the Tenant Improvement Standards included in Exhibit A, using Building Standard Materials (BSM) which BSM's shall be subject to change as reasonably determined by Landlord. Any costs for Landlord's Work as a result of a change order use of the alternate items described in Exhibit A or Tenant delay shall be paid for by Tenant to Landlord within fifteen (15) days of receipt of written demand for such costs from Landlord.

SECTION 2 IMPROVEMENTS PROVIDED AT TENANT'S EXPENSE.

Unless otherwise agreed by Landlord and Tenant in an addendum attached to the Lease, all improvements constructed in the Premises in addition to those listed in Section 1 of this Work Agreement shall be approved in writing by Landlord pursuant to Section 3 of this Work Agreement and the cost thereof, including the cost of obtaining all necessary permits and approvals, shall be paid by Tenant.

SECTION 3 DESIGN OF TENANT IMPROVEMENTS.

Tenant shall retain the services of a licensed qualified architect or engineer, approved in advance by Landlord, to prepare the necessary drawings, including, without limitation, Basic Plans and Working Plans as described below for construction of the tenant improvements ("Tenant's Plans"). All Tenant's Plans shall be prepared at Tenant's expense and shall be subject to the prior written approval of Landlord.

Tenant's architect or engineer shall determine that the work shown on Tenant's Plans is compatible with the basic Building plans and that necessary basic Building modifications are included in Tenant's Plans. All such modifications, including, without limitation, all penetrations of the Building shell, shall be subject to Landlord's approval and the cost thereof shall be paid by Tenant.

The Basic Plans shall include (i) fully dimensional architectural floor plans showing partition layout, clearly identifying and locating equipment requiring special plumbing or mechanical systems, areas subject to above normal loads, special openings in the floor, ceiling, or walls, and other major or special features; (ii) fully dimensional plans locating telephone and electrical receptacles, outlets, and other items requiring electrical power (for special conditions, equipment, power requirements, and manufacturer's model numbers must be included); (iii) a lighting layout showing locations of all light fixtures and partitions; and (iv) any proposed alterations in or about the Premises. Four sets of the Basic Plans shall be delivered to Landlord within _____ days after Reference Date of the Lease.

Landlord shall review the Basic Plans and shall either approve the Basic Plans or reject them, in which case Landlord shall specify the deficiencies in the Basic Plans as submitted. If the Basic Plans are rejected, Tenant shall resubmit revised Basic Plans as soon as practicable until Landlord's approval has been obtained. Following Landlord's approval of the Basic Plans, Tenant's architect or engineer shall produce full working drawings for construction sufficient to obtain all necessary permits and with sufficient detail to construct the improvements, including specifications for every item included thereon (the "Working Plans"). The Working Plans shall be delivered to Landlord within thirty (30) days after Landlord's approval of the Basic Plans.



Tenant shall be responsible for delays and additional costs in completion of Tenant's improvements caused by changes made to any of Tenant's Plans after the delivery dates specified above in this Section 3, by inadequacies in any of Tenant's Plans, or by delays in delivery of special materials requiring long lead times, and for any other costs or expenses that do not result from the negligence or default of Landlord.

SECTION 4 CONSTRUCTION OF TENANT IMPROVEMENTS.

Upon completion of the Working Plans and at the request of Tenant, Landlord and its contractor shall provide to Tenant in writing an estimate of the cost of improvements to be provided at Tenant's expense pursuant to Section 2 of this Work Agreement. Within five (5) days after Tenant's receipt of such estimated cost, Tenant shall delete any items which Tenant elects not to have constructed and shall authorize construction of the balance of the improvements. In the absence of such written authorization, Landlord shall not be obligated to commence work on the Premises and Tenant shall be responsible for any costs due to any resulting delay in completion of the Premises. If required by Landlord's contractor, Tenant shall enter into a construction contract with respect to the construction of its improvements. Notwithstanding the provisions of this Section 4, Tenant may request Landlord's approval to use a contractor other than Landlord's for the construction of Tenant's improvements. Tenant shall include with any request for such approval a written estimate by Tenant's contractor of the cost of the improvements. Landlord shall respond to any request for such approval within ten (10) days after receipt of the request. If Landlord approves Tenant's request to use its own contractor, the work performed by such contractor shall be in conformance with the provisions of Section 4 of this Work Agreement.

If Landlord's contractor is to construct Tenant's improvements, then prior to commencement of construction of the improvements, Tenant shall either (i) deposit with Landlord cash in an amount equal to the estimated cost of the improvements to be installed at Tenant's expense pursuant to Section 2 of this Work Agreement; or (ii) provide Landlord with other evidence or assurance, such as a bond or letter of credit, satisfactory to Landlord of Tenant's ability to pay the estimated cost of such improvements. Landlord's contractor shall then complete the improvements in accordance with the Working Plans. Any additional amounts payable by Tenant for the actual cost of the improvements shall be paid on or before the Commencement of the Lease, or upon receipt of the final accounting. If cash is deposited by Tenant as provided above in this Section 4, any excess paid by Tenant over the actual cost of the improvements shall be promptly refunded to Tenant by Landlord.

If Tenant desires any change to its improvements, Tenant shall submit a written request for such change to Landlord, together with all plans and specifications necessary to show and explain changes from the approved Working Plans. Any such change shall be subject to Landlord's approval. If Landlord's contractor is constructing Tenant's improvements, Landlord or such contractor shall notify Tenant in writing of the amount, if any, which will be charged or credited to Tenant to reflect the cost of such change.

If any work is to be performed in connection with the improvements on the Premises by Tenant's contractor as provided in Section 4 of this Work Agreement, such work shall conform to the following requirements:

- 4.1.1 Such work shall proceed only upon Landlord's written approval of the public liability and property damage insurance carried by Tenant's contractor. Landlord shall have the right to require Tenant's contractor to post a payment or performance bond in an amount equal to the estimated cost of the work to be performed by such contractor. Tenant shall supply Landlord with the name, address, and emergency telephone number for Tenant's contractor and all subcontractors retained by Tenant's contractor.
- 4.1.2 All such work shall be done in conformity with a valid building permit and other permits when required, a copy of which shall be furnished to Landlord before such work is commenced, and in any case, all such work shall be performed in accordance with all applicable governmental regulations and all applicable safety regulations established by Landlord or its contractor for the Building generally. Notwithstanding any failure by Landlord to object to any such work, Landlord shall have no responsibility for Tenant's failure to comply with all applicable governmental regulations.

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- 4.1.3 Landlord may require that all such work be performed by union labor in accordance with any union labor agreements applicable to the trades being employed at the Building.
- 4.1.4 All such work shall be scheduled through Landlord and shall be performed in a manner and at times which do not impede or delay any work on the Premises being performed by Landlord's contractor.
- 4.1.5 Tenant's contractor shall store any materials only in the Premises or in such other space as may be designated by Landlord or its contractor from time to time. All trash and surplus construction materials shall also be stored within the Premises and shall be promptly removed from the Building.

Tenant's entry into the Premises for any purpose, including without limitation inspection or performance of work by Tenant's contractor, prior to the Commencement Date, shall be subject to all the terms and conditions of the Lease, including without limitation the provisions of the Lease relating to the maintenance of insurance and indemnification by Tenant, but excluding the provisions of the Lease relating to the payment of rent. Tenant's entry shall mean entry by Tenant, its officers, contractors, licensees, agents, servants, employees, guests, invitees, or visitors.

Tenant shall indemnify and hold harmless Landlord from and against any and all claims, losses, liabilities, and expenses (including without limitation attorney fees) arising out of or in any way related to the activities of Tenant's contractors (and any subcontractors) in the Premises or the Building. Without limiting the generality of the foregoing, Tenant shall promptly reimburse Landlord upon demand for any extra expense incurred by the Landlord as a result of faulty work done by Tenant or its contractors, any delays caused by such work, or inadequate clean-up.

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EXHIBIT "C"
Rules & Regulations

1. The entrances, halls, corridors, stairways, exits, and elevators shall not be obstructed by any of the tenants or used for any purpose other than for ingress from their respective premises. The entrances, halls, corridors, stairways, exits, and elevators are not intended for use by the general public but for the tenant and its employees, licensees, and invitees. Landlord reserves the right to control and operate the public portions of the Building and the public facilities, as well as facilities furnished for the common use of the tenants, in such manner as it in its reasonable judgment deems best for the benefit of the tenants generally. No tenant shall invite to the tenants' premises, or permit the visit of, persons in such numbers or under such conditions as to interfere with the use and enjoyment of any of the plazas, entrances, corridors, elevators, and other facilities of the Building by any other tenants. Fire exits and stairways are for emergency use only, and they will not be used for any other purpose.
 2. Landlord may refuse admission to the Building outside of the business hours of the Building to any person not producing identification satisfactory to Landlord. If Landlord issues identification passes, Tenant shall be responsible for all persons for whom it issues any such pass and shall be liable to Landlord for all acts or omissions of such persons.
 3. No awnings or other projections shall be attached to the outside walls of the Building. No curtains, blinds, shade, or screens, if any, which are different from the standards adopted by Landlord for the Building shall be attached to or hung in any exterior window or door of the premises of any tenant without the prior written consent of Landlord.
 4. No sign, placard, picture, name lettering, advertisement, notice, or object visible from the exterior of any tenant's premises shall be displayed in or on the exterior windows or doors, or on the outside of any tenant's premises, or at any point inside any tenant's premises where the same might be visible outside of such premises, without the prior written consent of Landlord. Landlord may adopt and furnish to tenants general guidelines relating to signs inside the Building and Tenant shall conform to such guidelines. All approved signs or lettering shall be prepared, printed, affixed, or inscribed at the expense of the tenant and shall be of a size, color, and style acceptable to Landlord.
 5. The windows that reflect or admit light and air into the halls, passageways, or other public places in the Building shall not be covered or obstructed by any tenant, nor shall any bottles, parcels, or other articles be placed on the windowsills.
 6. No showcases or other articles shall be put in front of or affixed to any part of the exterior of the Building, nor placed in the halls, corridors, or vestibules.
 7. No bicycles, vehicles, animals, fish, or birds of any kind shall be brought into or kept in the premises of any tenant or the Building.
 8. No noise, including, but not limited to, music or the playing of musical instruments, recordings, radio or television, which, in the judgment of Landlord, might disturb other tenants in the Building, shall be made or permitted by any tenant.
 9. No tenant, nor any tenant's contractors, employees, agents, visitors, invitees or licensees, shall at any time bring into or keep upon the premises or the Building any inflammable, combustible, explosive, environmentally hazardous or otherwise dangerous fluid, chemical, or substance.
 10. All movement of freight, furniture, packages, boxes, crates, or any other object or matter of any description must take place during such hours and in such elevators, and in such manner as Landlord or its agent may determine from time to time. Any labor and engineering costs incurred by Landlord in connection with any moving herein specified, shall be paid by Tenant to Landlord, on demand.
 11. No tenant shall use its premises, or permit any part thereof to be used, for manufacturing or the sale at retail or auction of merchandise, goods, or property of any kind, unless said use is consistent with the use provisions of the Lease.
 12. Landlord shall have the right to prescribe the weight and position of safes and other objects of excessive weight, and no safe or other object whose weight exceeds the lawful load for the area upon which it would stand shall be brought into or kept upon any tenant's premises. If, in the judgement of Landlord, it is necessary to distribute the concentrated weight of any heavy object, the work involved in such distribution shall be done at the expense of the tenant and in such manner as Landlord shall determine.
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13. Landlord, its contractors, and their respective employees, shall have the right to use, without charge therefor, all light, power, and water in the premises of any tenant while cleaning or making repairs or alterations in the premises of such tenant.
14. No premises of any tenant shall be used for lodging or sleeping or for any immoral or illegal purpose.
15. The requirements of tenants for any services by Landlord will be attended to only upon prior application to the Landlord. Employees of Landlord shall not perform any work or do anything outside of their regular duties, unless under special instructions from Landlord.
16. Canvassing, soliciting, and peddling in the Building are prohibited and each tenant shall cooperate to prevent the same.
17. Each tenant shall store its trash and garbage within its premises. No material shall be placed in the trash boxes or receptacles if such material is of such nature that it may not be disposed of in the ordinary and customary manner of removing and disposing of office building trash and garbage in the area of the Building without being in violation of any law or ordinance governing such disposal. All garbage and refuse disposal shall be made only through entryways and elevators provided for such purposes and at such times as Landlord shall designate. No tenant shall cause or permit any unusual or objectionable odors to emanate from its premises which would annoy other tenants or create a public or private nuisance.
18. No coin vending machine, video game, coin or token operated amusement device, or similar machine shall be used or installed in any tenant's premises without Landlord's prior written consent.
19. No bankruptcy, going out of business, liquidation, or other form of distress sale shall be held on any of tenant's premises. No advertisement shall be done by loudspeaker, barkers, flashing lights, or displays or other methods not consistent with the character of an office building.
20. Nothing shall be done or permitted in any tenant's premises, and nothing shall be brought into or kept in any tenant's premises, which would impair or interfere with the economic heating, cleaning, or other servicing of the Building or the premises, or the use or enjoyment by any other tenant of any other premises, nor shall there be installed by any tenant any ventilating, air conditioning, electrical, or other equipment of any kind which, in the reasonable judgment of Landlord, might cause any such impairment or interference.
21. No acids, vapors, or other similar caustic materials shall be discharged or permitted to be discharged into the waste lines, vents, or flues of the Building. The water and wash closets and other plumbing fixtures in or serving any tenant's premises shall not be used for any purpose other than the purposes for which they were designed or constructed, and no sweepings, rubbish, rags, acids, or other foreign substances shall be deposited therein. All damages resulting from any misuse of the fixtures shall be borne by the tenant who, or whose servants, employees, agents, invitees, visitors, or licensees shall have caused the same.
22. All entrance doors in each tenant's premises shall be left locked and all windows shall be left closed by the tenant when the tenant's premises are not in use. Entrance doors to the tenant's premises shall not be left open at any time. Each tenant, before closing and leaving its premises at any time, shall turn out all lights.
23. Hand trucks not equipped with rubber tires and side guards shall not be used within the Building.
24. Landlord reserves the right to rescind, modify, alter, or waive any rule or regulation at any time prescribed for the Building when, in its reasonable judgment, it deems it necessary, desirable or proper for its best interest and for the best interests of the tenants generally, and no alteration or waiver of any rule or regulation in favor of any tenant shall constitute a waiver or alteration in favor of any other tenant. Landlord shall not be responsible to any tenant for the nonobservance or violation by any other tenant of any of the rules and regulations at any time prescribed for the Building.
25. Landlord reserves the right to add to, modify, or otherwise change these Rules and Regulations. Such changes shall become effective when written notice thereof is provided to tenants of the Building.

Subsidiaries of Pixelworks, Inc.

Equator Technologies, Inc. — a Delaware corporation

Jaldi Semiconductor — an Ontario corporation

nDSP Delaware, Inc. — a Delaware corporation

Panstera, Inc. — a California corporation

Pixelworks Japan Inc. — a Japan company

Pixelworks Ltd. — a Cayman Island company

Pixelworks Semiconductor Technology (Shanghai) Co. Ltd. — a China company

Pixelworks Semiconductor Technology (Taiwan) Inc. — a Taiwan company

CERTIFICATION

I, Bruce A. Walicek, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pixelworks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2008

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

CERTIFICATION

I, Steven L. Moore, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pixelworks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2008

By: /s/ Steven L. Moore

Steven L. Moore

*Vice President, Chief Financial Officer, Secretary and
Treasurer*

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

In connection with the Quarterly Report of Pixelworks, Inc. (the "Company") on Form 10-Q for the quarterly period ended September 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bruce A. Walicek, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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

Date: November 7, 2008

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

In connection with the Quarterly Report of Pixelworks, Inc. (the "Company") on Form 10-Q for the quarterly period ended September 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Steven L. Moore, Vice President, Chief Financial Officer, Secretary and Treasurer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Steven L. Moore
Steven L. Moore
*Vice President, Chief Financial Officer, Secretary
and Treasurer*

Date: November 7, 2008