UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2004

or

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

For the transition period from to

Commission File Number: 000-30269

PIXELWORKS, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

Number of shares of Common Stock outstanding as of April 30, 2004: 45,961,249

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Condensed Consolidated Balance Sheets
Condensed Consolidated Statements of Operations
Condensed Consolidated Statements of Cash Flows
Notes to Condensed Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II – OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

SIGNATURES

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

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

	March 31, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 90,244	$ 75,165
Short-term marketable securities	10,992	5,656
Accounts receivable, net	17,082	8,468
Inventories, net	9,779	10,478
Prepaid expenses and other current assets	3,541	4,826
Total current assets	131,638	104,593
Long-term marketable securities	23,591	19,875
Property and equipment, net	6,255	6,561
Other assets, net	6,676	16,205
Acquired intangible assets, net	3,281	3,535
Goodwill	82,548	82,548
Total assets	$ 253,989	$ 233,317
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 9,224	$ 4,330
Accrued liabilities	11,722	8,682
Total current liabilities	20,946	13,012
Shareholders' equity:		
Preferred stock	—	—
Common stock	298,507	294,235
Shares exchangeable into common stock	6,365	7,888
Deferred stock-based compensation	(328)	(449)
Accumulated other comprehensive income	3,315	—
Accumulated deficit	(74,816)	(81,369)
Total shareholders' equity	233,043	220,305
Total liabilities and shareholders' equity	$ 253,989	$ 233,317

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

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

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Revenue	$ 45,270	$ 32,005
Cost of revenue (1)	21,575	17,292
Gross profit	23,695	14,713
Operating expenses:		
Research and development (2)	7,254	6,747
Selling, general and administrative (3)	6,232	5,388
Merger related expenses	—	1,580
Stock-based compensation and amortization of assembled workforce	285	404
Total operating expenses	13,771	14,119
Income from operations	9,924	594
Interest income	236	385
Interest expense	(1)	(6)
Interest income, net	235	379
Income before income taxes	10,159	973
Provision for income taxes	3,606	725
Net income	$ 6,553	$ 248
Net income per share:		
Basic	$ 0.14	$ 0.01
Diluted	$ 0.14	$ 0.01
Weighted average shares outstanding:		
Basic	46,320	45,030
Diluted	48,141	46,347

(1) Includes amortization of:		
Acquired developed technology	$ 132	$ 132
Deferred stock-based compensation	—	2
(2) Excludes stock-based compensation of:	80	155
(3) Excludes stock-based compensation of:	84	7

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

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

	Three Months Ended March 31,	
	2004	2003
Cash flows from operating activities:		
Net income	$ 6,553	$ 248
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,428	1,615
Stock-based compensation and amortization of assembled workforce	285	406
Loss on asset disposals	163	—
Amortization of acquired developed technology	132	132
Amortization of deferred tax charge	14	—
Deferred rent	3	—
Changes in operating assets and liabilities		
Accounts receivable, net	(8,614)	1,531
Inventories, net	699	(3,607)
Prepaid expenses and other current and long-term assets	1,276	485
Accounts payable	4,894	1,659
Accrued liabilities	2,977	1,333
Net cash provided by operating activities	9,810	3,802
Cash flows from investing activities:		
Purchases of property and equipment	(975)	(1,365)
Purchases of other assets	(786)	—
Purchases of marketable securities	(2,737)	(7,470)
Proceeds from maturities of marketable securities	7,000	31,800
Net cash provided by investing activities	2,502	22,965
Cash flows from financing activities:		
Proceeds from issuances of common stock	2,706	635
Lease incentives	62	—
Payments on long-term debt	(1)	(83)
Net cash provided by financing activities	2,767	552
Net increase in cash and cash equivalents	15,079	27,319
Cash and cash equivalents, beginning of period	75,165	62,152
Cash and cash equivalents, end of period	$ 90,244	$ 89,471
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest	$ 1	$ 6
Income taxes	1	—
Supplemental disclosure of non-cash investing and financing activities:		
Transfer of cost-based investment to available-for-sale marketable security	$ 10,000	$ —

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

NOTE 1: BASIS OF PRESENTATION

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

The financial information included herein for the three months ended March 31, 2004 and 2003 is unaudited; however, such information reflects all 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, 2003 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2003, included in Item 8 of our Annual Report on Form 10-K, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2004.

Certain reclassifications have been made to the prior year condensed consolidated financial statements to conform to the current year presentation.

NOTE 2: STOCK PLANS

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

As permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), and SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an Amendment of FASB Statement No. 123*, we continue to apply the intrinsic value based method of accounting for stock compensation described in APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"). Entities electing to continue to apply Opinion 25 must make prominent pro-forma disclosures of net income and earnings per share as if the fair value based method prescribed by SFAS 123 had been applied. Had we accounted for our stock-based compensation plans in accordance with SFAS 123, our net income would approximate the pro-forma amounts below:

	Three Months Ended March 31,	
	2004	2003
Net income as reported	$ 6,553	$ 248
Add: Stock-based compensation included in reported net loss, net of related tax effects	100	100
Deduct: Stock-based compensation determined under the fair value based method, net of related tax effects	(2,095)	(2,143)
Pro-forma net income (loss)	$ 4,558	$ (1,795)
Reported diluted net income per share	$ 0.14	$ 0.01
Pro-forma diluted net income (loss) per share	$ 0.09	$ (0.04)

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

	Three Months Ended March 31,	
	2004	2003
Stock Option Plans:		
Risk free interest rate	3.51%	2.92%
Expected dividend yield	0%	0%
Expected life (in years)	6.1	5.5
Volatility	103%	113%
Employee Stock Purchase Plan:		
Risk free interest rate	1.90%	1.84%
Expected dividend yield	0%	0%
Expected life (in years)	1.6	1.2
Volatility	104%	101%

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

NOTE 3: BALANCE SHEET COMPONENTS

Marketable Securities

We categorize our marketable securities in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS 115"). As of March 31, 2004 and December 31, 2003, all balances included in short-term marketable securities are classified as held-to-maturity. As of December 31, 2003, all balances included in long-term marketable securities are classified as held-to-maturity, however as of March 31, 2004, long-term marketable securities consist of held-to-maturity securities and an available-for-sale security as follows:

Held-to-maturity securities	$	10,276
Available for sale security		13,315
	$	23,591

Held-to-maturity marketable securities are stated at amortized cost in the condensed consolidated balance sheets. We have the positive intent and ability to hold these securities until maturity. Unrealized gains and losses on held-to-maturity marketable securities were not material at March 31, 2004 and December 31, 2003.

The available-for-sale security is stated at fair value in the condensed consolidated balance sheet. The available-for-sale security balance represents the fair value of our investment in Semiconductor Manufacturing International Corporation ("SMIC") at March 31, 2004. We made a $10,000 investment in SMIC during the third quarter of 2003 and recorded it at cost in other long-term assets at December 31, 2003. In March of 2004, SMIC completed its initial public offering and as a result, we now account for the investment as an available-for-sale security in accordance with SFAS 115. At March 31, 2004, the $3,315 unrealized holding gain on our SMIC investment is recorded in other comprehensive income, a component of shareholders' equity.

Accounts Receivable

Accounts receivable are recorded at invoiced amount and do not bear interest. 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 resulting from the inability of our customers to make required payments. Accounts receivable, net consist of the following:

		March 31, 2004		December 31, 2003
Accounts receivable, gross	$	17,294	$	8,680
Allowance for doubtful accounts		(212)		(212)
Accounts receivable, net	$	17,082	$	8,468

Inventories

Inventories consists 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 consist of the following:

	March 31, 2004	December 31, 2003
Finished goods	$ 6,513	$ 7,134
Work-in-process	3,266	3,344
	$ 9,779	$ 10,478

The reserve for slow moving and obsolete items was $1,314 and $1,942 at March 31, 2004 and December 31, 2003, respectively.

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

Accrued Liabilities

Accrued liabilities consist of the following:

	March 31, 2004	December 31, 2003
Payroll and related liabilities	$ 2,377	$ 3,502
Accrued manufacturing liabilities	1,885	1,179
Accrued royalties and sales commissions	843	656
Reserve for sales returns and allowances	257	202
Reserve for warranty returns	533	569
Income taxes payable	2,993	—
Other	2,834	2,574
	$ 11,722	$ 8,682

The following is a summary of the change in our reserve for sales returns and allowances for the three months ended March 31, 2004 and 2003:

	Three Months Ended March 31,	
	2004	2003
Beginning balance	$ 202	$ 588
Provision	57	42
Charge offs	(2)	(61)
Ending balance	$ 257	$ 569

The following is a summary of the change in our reserve for warranty returns for the three months ended March 31, 2004 and 2003:

	Three Months Ended March 31,	
	2004	2003
Beginning balance	$ 569	$ 769
Provision	(21)	82
Charge offs	(15)	(63)
Ending balance	$ 533	$ 788

Accumulated Other Comprehensive Income

As of March 31, 2004, we had an unrealized gain, net of tax, on our available-for-sale investment in SMIC of $3,315. This unrealized gain was recorded during the period in accumulated other comprehensive income. Total comprehensive income for the three months ended March 31, 2004 is as follows:

Net income	$ 6,553
Unrealized gain on available-for-sale marketable securities, net of tax	3,315
Comprehensive income	$ 9,868

NOTE 4: EARNINGS PER SHARE

The shares used in the computation of basic and diluted net income per share are as follows:

	Three Months Ended March 31,	
	2004	2003
Weighted average common shares outstanding, basic	46,320	45,030
Dilutive effect of employee stock options and vesting of restricted stock	1,821	1,317
Weighted average common shares outstanding, diluted	48,141	46,347

The computation of basic weighted average common shares outstanding includes exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 by Jaldi, our

Canadian subsidiary, to its shareholders in connection with our Jaldi asset acquisition, have characteristics essentially equivalent to Pixelworks common stock.

For the three months ended March 31, 2004 and 2003, respectively, approximately 1,271 and 4,109 weighted average shares related to stock options were excluded from the calculation of diluted weighted average shares outstanding because the exercise prices of these options were equal to or greater than the average market price of Pixelworks common stock during these periods, and as a result, their inclusion would have been anti-dilutive.

NOTE 5: SEGMENT INFORMATION

In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, we have identified a single operating segment: the design and development of integrated circuits for electronic display devices. Substantially all of our assets are located in the U.S.

Geographic Information

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

	Three Months Ended March 31,	
	2004	2003
Japan	$ 17,441	$ 14,871
Taiwan	11,643	6,121
China	6,808	2,023
Korea	4,274	5,047
Europe	2,378	1,574
U.S.	585	371
Other	2,141	1,998
	$ 45,270	$ 32,005

Significant Customers

Sales to distributors represented 71% and 66% of total revenue for the three months ended March 31, 2004 and 2003, respectively. The following distributors accounted for 10% or more of total revenue for the periods presented:

	Three Months Ended March 31,	
	2004	2003
Distributor A	31%	44%
Distributor B	17%	11%

There was one end customer that represented 12% of total revenue for the three months ended March 31, 2004. There were no end customers that represented more than 10% of total revenue for the three months ended March 31, 2003. Sales to our top five end customers represented 37% of total revenue for the three months ended March 31, 2004 and 2003. End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and contract manufacturers.

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

	March 31, 2004	December 31, 2003
Account A	24%	20%
Account B	22%	33%
Account C	10%	4%
Account D	5%	11%

NOTE 6: GENESIS MICROCHIP TRANSACTION

On March 17, 2003, we announced the execution of a definitive merger agreement with Genesis Microchip. On August 5, 2003, we entered into an agreement terminating the merger agreement. In the termination agreement, we agreed to pay a termination fee of $5,500 to Genesis Microchip. The fee was payable upon execution of the termination agreement, and was recognized as an expense in the third quarter of 2003. Total expenses related to the proposed merger during the quarter ended March 31, 2003 were $1,580.

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

Forward-looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Report contain "forward-looking statements" within the meaning of the Securities Litigation Reform Act of 1995 that are based on current expectations, estimates, beliefs, assumptions and projections about our business. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates" and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. Actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors. Such factors include, but are not limited to, increased competition, continued adverse economic conditions in the U.S. and internationally, including adverse economic conditions in the specific markets for our products, adverse business conditions, failure to design, develop and manufacture new products, lack of success in technological advancements, lack of acceptance of new products, unexpected changes in the demand for our products and services, the inability to successfully manage inventory pricing pressures, failure to reduce costs or improve operating efficiencies, changes to and compliance with international laws and regulations, currency fluctuations and our ability to attract, hire and retain key and qualified employees. These forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Report on Form

10-Q. If we do update or correct one or more forward-looking statements, you should not conclude that we will make additional updates or corrections with respect thereto or with respect to other forward-looking statements.

(Dollars and shares in thousands)

Overview

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

We sell our products worldwide through a direct sales force and indirectly through distributors and manufacturers representatives. We sell to distributors in Japan, Taiwan, China and Europe. Sales to distributors represented 71% and 66% of total revenue for the three months ended March 31, 2004 and 2003, respectively. Manufacturers representatives support some of our European and Korean sales.

Historically, significant portions of our revenue have been generated by sales to a relatively small number of end customers and distributors. Our top five end customers accounted for 37% of our total revenue for the three months ended March 31, 2004 and 2003. End customers are customers that indirectly purchase our products through distributors and contract manufacturers as well as directly from us.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for approximately 99% of total revenue for the three months ended March 31, 2004 and 2003. Our integrators, branded manufacturers and branded suppliers incorporate our products into systems that are sold worldwide. All revenue to date has been denominated in U.S. dollars.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. On an on-going basis, we evaluate our estimates, including those related to product returns, warranty obligations, inventories, property and equipment, intangible assets, income taxes, litigation and other contingencies. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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

Revenue Recognition. We recognize revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition*. Accordingly, revenue is recognized when an authorized purchase order has been received, the sales price is fixed and determinable, title has transferred, collection of the resulting receivable is probable and product returns are reasonably estimable. This generally occurs upon shipment of the underlying merchandise for product sales to direct customers. This also occurs upon shipment of the underlying merchandise for product sales to distributors if the distributor has a firm sales commitment from an end customer.

Sales Returns and Allowances. Our customers do not have a stated right to return product other than under our warranty policy discussed below. As such, customer returns are accepted on a case-by-case basis only as a customer accommodation. However, certain of our distributors have stock rotation provisions in their distributor agreements, which allow them to return 5-10% of the products purchased in the prior six months in exchange for products of equal value. Certain distributors also have price protection provisions in their agreements with us.

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

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

We record the estimated cost of product warranties in our warranty reserve. We update the balance in this reserve based on historical experience at each reporting period. While we engage in extensive product quality programs and processes, which include actively monitoring and evaluating the quality of our suppliers, should actual product failure rates or product replacement costs differ from our estimates, revisions to the estimated warranty liability may be required.

Allowance for Doubtful Accounts. We offer credit to customers after careful examination of their creditworthiness. We maintain an allowance for doubtful accounts for estimated losses that may result from the inability of our customers to make required payments. We update the balance in the allowance based on historical experience and the age of outstanding receivables at each reporting period. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventory Valuation. We record a reserve against our inventory for estimated obsolete, unmarketable, and otherwise impaired products by calculating the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. We review our inventory at the end of each reporting period for valuation issues. If actual market conditions are less favorable than those projected by us at the time the reserve was recorded, additional inventory write-downs may be required.

Useful Lives and Recoverability of Equipment and Other Long-Lived Assets. We evaluate the remaining life and recoverability of equipment and other assets, including identifiable intangible assets with definite lives, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. If there is an indication of impairment, we prepare an estimate of future, undiscounted cash flows expected to result from the use of each asset and its eventual disposition. If these cash flows are less than the carrying value of the asset, we adjust the carrying amount of the asset to its estimated fair value.

Goodwill. Goodwill, which represents the excess of cost over the fair value of net assets acquired in business combinations, is tested annually for impairment, and is tested for impairment more frequently if events and circumstances indicate that it might be impaired. The impairment tests are performed in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* Accordingly, an impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. This determination is made at the reporting unit level. We have assigned all goodwill to a single, enterprise-level reporting unit. The impairment test consists of two steps. First, we determine the fair value of the reporting unit. The fair value is then compared it to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation in accordance with SFAS No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. We perform our annual impairment test in the first quarter of each year. We did not record any impairment losses against goodwill when we performed the test in the first quarter of 2004 or 2003.

Income Taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Should we determine that we will not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

Results of Operations

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

	Three Months Ended March 31,			
	2004		2003	
	Dollars	% of sales	Dollars	% of sales
Revenue	$ 45,270	100.0%	$ 32,005	100.0%
Cost of revenue	21,575	47.7	17,292	54.0
Gross profit	23,695	52.3	14,713	46.0
Operating expenses:				
Research and development	7,254	16.0	6,747	21.1
Selling, general and administrative	6,232	13.8	5,388	16.8
Merger related expenses	—	0.0	1,580	4.9
Stock-based compensation and amortization of assembled workforce	285	0.6	404	1.3
Total operating expenses	13,771	30.4	14,119	44.1
Income from operations	9,924	21.9	594	1.9
Interest income	236	0.5	385	1.2
Interest expense	(1)	0.0	(6)	0.0
Interest income, net	235	0.5	379	1.2
Income before income taxes	10,159	22.4	973	3.0
Provision for income taxes	3,606	8.0	725	2.3
Net income	$ 6,553	14.5%	$ 248	0.8%

Percentages may not add due to rounding.

Revenue

Revenue increased 41.4% to $45,270 for the three months ended March 31, 2004 from $32,005 for the three months ended March 31, 2003. Revenue by market as a percentage of total revenue was as follows:

	Three Months Ended March 31,	
	2004	2003
Multimedia projectors	49%	58%
Advanced televisions	38%	14%
LCD monitors	10%	24%
Other	3%	4%

Multimedia Projectors

Total revenue from multimedia projector sales increased 20% from $18,632 in the first quarter of 2003 to $22,392 in the first quarter of 2004. Units shipped increased 39%, while average selling prices decreased 14%. The growth in unit shipments and decrease in average selling prices were driven primarily by the sub-$1,000 and consumer segments of the projector market continuing to expand.

Consistent with the first quarter of 2003, the majority of our sales to multimedia projector manufacturers were to customers located in Japan. Japanese customers accounted for 64% and 67% of total projector revenue for the three months ended March 31, 2004 and 2003, respectively.

We believe that second quarter 2004 projector revenue is weekly to be flat or down 5% from the first quarter. We expect some of this decline to be seasonal, and result from the fact that the fiscal year of our Japanese customers ends on March 31. These customers tend to build as much product as possible by the end of March, and then build less at the beginning of their first quarter.

Advanced Televisions

Total revenue from advanced television sales increased 283% from $4,500 in the first quarter of 2003 to $17,217 in the first quarter of 2004. Units shipped increased 412%, while average selling prices decreased 25%. The unit growth was attributable to growth in the overall market for advanced televisions as well as possible market share gains in selected segments of the overall advanced television market.

In the first quarter of 2004, sales of our products to be used in liquid crystal display (“LCD”) TV’s comprised 54% of total advanced television sales, while digital cathode ray tube (“CRT”) TV’s comprised 26%, plasma TV’s comprised 18% and digital rear projection TV’s comprised 2%. The majority of our television revenue is generated on sales to customers in China, Taiwan and Korea, with sales to television manufacturers in these three countries comprising 81% and 74% of total television revenue for the three months ended March 31, 2004 and 2003, respectively.

We expect sequential growth of 15-20% in advanced television revenue during the second quarter of 2004, and believe that the advanced television market as a whole will grow at 75-100% this year. In the second quarter, we expect LCD televisions to continue to be our top revenue generator, followed by digital CRTs, plasma televisions and digital rear projection televisions.

LCD Monitors

Total revenue from LCD monitor sales decreased 38% from $7,627 in the first quarter of 2003 to $4,752 in the first quarter of 2004. Units shipped decreased 36% and average selling prices decreased 3%. The relatively small decrease in average selling prices was attributable to an increase in the percentage of chips sold into Ultra Extended Graphics Array (“UXGA”) monitors in the first quarter of 2004, which carry higher average selling prices than chips sold into Super Extended Graphics Array (“SXGA”) or Extended Graphics Array (“XGA”) monitors. Sales of chips to be used in UXGA monitors increased 58% from the first quarter of 2003 to the first quarter of 2004, and comprised 44% of total monitor revenue in the first quarter of 2004. Sales of chips to be used in SXGA monitors decreased 59% from the first quarter of 2003 to the first quarter of 2004, and comprised 29% of total monitor business in the fourth quarter of 2004. Sales of chips to be used in XGA monitors decreased 63% from the first quarter of 2003 to the first quarter of 2004, and comprised 22% of total monitor business in the first quarter of 2004.

We expect sequential growth of 10-15% in LCD monitor revenue during the second quarter of 2004, and believe that we will see growth in all of our segments, including XGA, SXGA and UXGA resolutions.

Other

Other revenue includes sales of evaluation kits as well as the impact of changes in our reserve for sales returns. We do not expect other revenue to be significant in the near future.

Cost of sales and gross profit

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

Gross profit increased to 52.3% for the three months ended March 31, 2004 from 46.0% for the three months ended March 31, 2003. This increase is primarily driven by wafer and back-end product cost reductions that resulted from our increased volumes, as well as the sale of previously reserved end of life inventory.

We expect our gross profit margin to decrease to 47.0% to 49.0% in the second quarter of 2004. This decrease will result from increased product costs which we will incur to gain additional manufacturing capacity to meet growing demand, as well as a less favorable product mix in which projectors, which carry the highest margins, will represent a smaller percentage of total revenue.

Research and development

Research and development expense is primarily comprised of compensation and related costs for personnel, non-recurring engineering and development expenses, depreciation and amortization, expensed equipment and fees for outside services. Research and development expense, inclusive of stock-based compensation expense, was as follows:

	Three Months Ended March 31,	
	2004	**2003**
Research and development expense, inclusive of stock-based compensation	$ 7,334	$ 6,902

Research and development expense, inclusive of stock-based compensation expense, increased $432, or 6%, from the three months ended March 31, 2003 to the three months ended March 31, 2004 due to the following offsetting factors:

- Our development related expenses, including non-recurring engineering and outside services, increased $471. The fluctuation was attributable to the timing of projects in progress during the respective quarters.

- We recorded a $163 loss on the disposal of licensed technology during the three months ended March 31, 2004. We will no longer utilize the licensed technology in our product development efforts and we have no alternate uses for it.

- Expensed equipment and software increased $159.

- Depreciation and amortization decreased $195 due to lower capital expenditures.

- Stock-based compensation expense decreased $75 due to our use of the accelerated method of expense recognition, under which more expense is recognized in earlier periods.

- Compensation expense decreased $88. This decrease is attributable to a lower headcount in research and development departments at March 31, 2004 as compared to March 31, 2003. The decrease in headcount resulted from the restructuring that we initiated in the third quarter of 2003 to better position the Company to compete in the advanced television market. The decrease in headcount lead to lower salaries expense, which was partially offset by higher bonus and employee benefits expenses.

We expect our research and development expenses to continue increasing in future periods to support our on going investment in new product development programs.

Selling, general and administrative

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

	Three Months Ended March 31,	
	2004	2003
Selling, general and administrative expense, inclusive of stock-based compensation	$ 6,316	$ 5,395

Selling, general and administrative expense, inclusive of stock-based compensation expense, increased $921, or 17%, from the three months ended March 31, 2003 to the three months ended March 31, 2004 due to the following factors:

- Our selling, general and administrative compensation costs increased $330 from the three months ended March 31, 2003 to the three months ended March 31, 2004. The increase is directly attributable to an 11% increase in headcount. The increase in headcount was partially attributable to an increase in administrative, sales and marketing personnel required to support our growing revenue base.

- Outside services, including accounting and legal fees increased $116.

- Insurance expense increased $110 primarily related to higher Directors and Officers insurance premiums.

- Our travel and trade show expenses increased $80.

- Stock-based compensation expense increased $77 due to the modification of an employee stock option during the first quarter of 2004.

- Investor relations expense increased $51.

- Expensed equipment and software increased $36.

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

Merger-related expenses

On March 17, 2003, we announced the execution of a definitive merger agreement with Genesis Microchip. On August 5, 2003, we entered into an agreement terminating the merger. Merger-related expenses of $1,580 during the three months ended March 31, 2003 resulted from this proposed merger, and consisted primarily of legal fees.

Stock-based compensation and amortization of assembled workforce

Stock-based compensation and amortization of assembled workforce decreased $119, or 29%, from $404 for the three months ended March 31, 2003 to $285 for the three months ended March 31, 2004. The decrease is attributable to decreases in the carrying amount and quarterly amortization amount of the assembled workforce asset. These decreases resulted from a re-allocation of the Jaldi Semiconductor purchase price in 2003 due to an intellectual property asset purchase agreement that was entered into by Pixelworks, Inc. and Jaldi. As a result of the agreement, the original purchase price allocation was revised to reallocate $1,332 of the excess purchase price over the fair value of the net assets acquired from the assembled workforce asset to a deferred tax charge and a reduction in the deferred tax liability.

Stock-based compensation expense was consistent for the three months ended March 31, 2004 and 2003. This was attributable to two offsetting factors; a decrease in deferred stock-based compensation amortization due to our use of the accelerated method of expense recognition, under which more expense is recognized in earlier periods, offset by a charge to stock-based compensation expense due to a stock option modification during the quarter ended March 31, 2004.

Interest income, net

The decrease in interest income from the three months ended March 31, 2003 to the three months ended March 31, 2004 was primarily the result of lower yields on invested funds due to declining interest rates, as well as a greater proportion of investments in tax-exempt securities which have lower pre-tax yields than taxable securities.

Provision for income taxes

The provision for income taxes for the three months ended March 31, 2004 increased to $3,606 from $725 for the three months ended March 31, 2003. The increase in the provision was attributable to our increased projected income before taxes offset by various credits and other permanent items. The effective tax rate differs from the federal statutory rate primarily due to the utilization of various federal and state tax credits, as well as certain non-deductible items such as merger costs and an increase in our valuation allowance related to Jaldi's net operating losses in 2003.

Liquidity and Capital Resources

As of March 31, 2004 we had cash and cash equivalents of $90,244, short and long-term investments of $34,583 and working capital of $110,692. We anticipate that our cash and investment balances, along with cash expected to be generated from operations will be adequate to fund our operating and investing needs for the next twelve months and the foreseeable future. From time to time, we may evaluate acquisitions of businesses, products or technologies that compliment our business. Any such transactions, if consummated, may consume a material portion of our working capital or require the issuance of equity securities that may result in dilution to existing shareholders.

Accounts receivable, net increased to $17,082 at March 31, 2004 from $8,468 at December 31, 2003, and inventories, net decreased to $9,779 at March 31, 2004 from $10,478 at December 31, 2003. Average days sales outstanding increased to 34 at March 31, 2004 compared to 19 days at December 31, 2003. The increase in days sales outstanding and decrease in inventory are directly attributable to a greater portion of shipments in the third month of the first quarter of 2004 as compared to the third month of the fourth quarter of 2003.

Purchases of property and equipment of $975 during the three months ended March 31, 2004 were primarily for computer equipment and software. Purchases of other assets of $786 during the three months ended March 31, 2004 consisted of licensed technology.

Contractual Payment Obligations

A summary of our contractual commitments and obligations as of March 31, 2004 is as follows:

	Payments Due By Period				
Contractual Obligation	**Total**	**2004**	**2005 and 2006**	**2007 and 2008**	**2009 and beyond**
Operating Leases	$ 6,574	$ 2,692	$ 2,995	$ 818	$ 69
Estimated Q2 2004 purchase commitments to contract manufacturers	23,760	23,760	—	—	—

The lease payments above are net of sublease rentals of $73, $95 and $40 for the years ending December 31, 2004, 2005 and 2006, respectively.

Off-Balance Sheet Arrangements

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

RISK FACTORS

Investing in our shares of common stock involves a high degree of risk. If any of the following risks occur, the market price of our shares of common stock could decline and investors could lose all or part of their investment. Dollar amounts are in thousands.

RISKS RELATED TO OUR OPERATIONS

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

While we had $6,553 of net income in the three months ended March 31, 2004, our accumulated deficit is $74,816 through March 31, 2004. In the future we expect our research and development and selling, general and administrative expenses to increase. Given expected increases in operating expenses, we must increase revenues and gross profit to become profitable. We cannot be certain that we will achieve profitability in the future or, if we do, that we can sustain or increase profitability on a quarterly or annual basis. This may in turn cause the price of our common stock to decline. In addition, if we are not profitable in the future we may be unable to continue our operations.

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

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

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

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

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

Average selling prices for our products decline over relatively short time periods while many of our product costs are fixed. When our average selling prices decline, our revenues decline unless we are able to sell more units or reduce the cost to manufacture our products. Our operating results are negatively affected when revenue or gross profit margins decline. We have experienced these problems and expect that we will continue to experience them in the future, although we cannot predict when they may occur or how severe they will be.

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

The manufacture of semiconductors is a complex process and it is often difficult for semiconductor foundries to produce semiconductors free of defects. Because our products are more highly integrated than many other semiconductors and incorporate mixed analog and digital signal processing and embedded memory technology, they are even more difficult to produce without defects.

The ability to manufacture products of acceptable quality depends on both product design and manufacturing process technology. Since defective products can be caused by either design or manufacturing difficulties, identifying quality problems can occur only by analyzing and testing our semiconductors in a system after they have been manufactured. The difficulty in identifying defects is compounded because the process technology is unique to each of the multiple semiconductor foundries we contract with to manufacture our products. Failure to achieve defect-free products due to their increasing complexity may result in an increase in our cost and delays in the availability of our products. For example, we have experienced field failures of our ICs in certain customer system applications that required us to institute additional IC level testing. As a result of these field failures we incurred additional costs due to customers returning potentially affected products. Additionally, customers have experienced delays in receiving product shipments from us that resulted in the loss of revenue and profits.

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

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

Achieving a design win does not necessarily mean that a developer will order large volumes of our products. A design win is not a binding commitment by a developer to purchase our products. Rather, it is a decision by a developer to use our products in the design process of that developer's products. Developers can choose at any time to discontinue using our products in their designs or product development efforts. If our products are chosen to be incorporated into a developer's products, we may still not realize significant revenues from that developer if that developer's products are not commercially successful.

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

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

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

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

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

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

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

Our products incorporate software and software development tools. The integration of software adds complexity, may extend our internal development programs and could impact our customers' development schedules. This complexity requires increased coordination between hardware and software development schedules and may increase our operating expenses without a corresponding increase in product revenue. Some customers and potential customers may choose not to use our products because of the additional requirements of implementing our software, preferring to use a product that works with their existing software. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

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

We are and will continue to be dependent on a limited number of large distributors and customers for a substantial portion of our revenue. Sales to distributors represented 71% of our total revenue for the three months ended March 31, 2004, and 69%, 68% and 61% of total revenue for the years ending December 31, 2003, 2002 and 2001, respectively. During the three months ended March 31, 2004, sales to Tokyo Electron Device Limited ("TED"), our distributor in Japan, represented 31% of our total revenue. Sales to TED represented 39%, 45% and 52%, respectively, of our total revenue for the years ended December 31, 2003, 2002 and 2001. Sales to our top five end customers accounted for approximately 37% of our total revenue for the three months ended March 31, 2004, and 35%, 41% and 43% of our total revenue for the years ended December 31, 2003, 2002 and 2001, respectively. As a result of this customer and distributor concentration, any one of the following factors could significantly impact our revenues:

- a significant reduction, delay or cancellation of orders from one or more of our key distributors, branded manufacturers or integrators; or
- a decision by one or more significant customers to select products manufactured by a competitor, or its own internally developed semiconductor, for inclusion in future product generations.

The display manufacturing market is highly concentrated among relatively few large manufacturers. We expect our operating results to continue to depend on revenues from a relatively small number of distributors that sell our products to display manufacturers and their suppliers.

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

At March 31, 2004, we had three customers that represented more than 10% of our accounts receivable balance. TED represented 24% and 20% of out total accounts receivable at March 31, 2004 and December 31, 2003, respectively. Neoview, our distributor in Taiwan, represented 22% and 33% of total accounts receivable at March 31, 2004 and December 31, 2003, respectively. A third customer accounted for 10% of total accounts receivable at March 31, 2004. The failure of these or any other customer representing 10% or more of our total accounts receivable in the future to pay these balances would result in a significant expense that would increase our operating expenses and would reduce our cash flows.

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

Sales outside the U.S. accounted for approximately 99% of total revenue for the three months ended March 31, 2004 and 2003. Most of our customers are concentrated in Japan, Taiwan, China and Korea, with aggregate sales from those four countries accounting for 89% and 88% of our total revenue during the three months ended March 31, 2004 and 2003, respectively. 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 them outside of the U.S., thereby exposing us indirectly to foreign risks. In addition, all of our products are manufactured outside of the U.S. We are, therefore, subject to many international risks, including, but not limited to:

- increased difficulties in managing international distributors and manufacturers of our products and components due to varying time zones, languages and business customs;
- foreign currency exchange fluctuations such as the devaluation in the currencies of Japan, Taiwan and Korea that resulted in an increased cost of procuring our semiconductors;
- potentially adverse tax consequences, such as license fee revenue taxes imposed in Japan;
- difficulties regarding timing and availability of export and import licenses, which have limited our ability to freely move demonstration equipment and samples in and out of Asia;
- political and economic instability, particularly in China, Taiwan and Korea;
- reduced or limited protection of our intellectual property, significant amounts of which are contained in software, which is more prone to design piracy;
- increased transaction costs related to sales transactions conducted outside of the U.S. such as charges to secure letters of credit for foreign receivables;
- difficulties in maintaining sales representatives outside of the U.S. that are knowledgeable about the display processor industry and our display processor products;
- changes in the regulatory environment in China, Japan, Korea and Taiwan that may significantly impact purchases of our products by our customers; and
- difficulties in collecting accounts receivable.

Our growing presence and investment within the Peoples Republic of China subjects us to risks of economic and political instability in the area, which would adversely impact our results of operations.

A substantial and potentially increasing portion of our products are manufactured by foundries located in the Peoples Republic of China, or the PRC, and a large number of our customers are geographically concentrated in the PRC. In addition, approximately 25 percent of our employees are located in this area. We also made an investment of $10,000 in a foundry located in Shanghai, China in the third quarter of 2003. Disruptions from natural disasters, health epidemics and political, social and economic instability may affect the region, and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to State plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot assure, however, that the PRC government's policies for economic reforms will be consistent or effective. Our results of operations and financial position may be harmed by changes in the PRC's political, economic or social conditions.

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

Selling through distributors reduces our ability to forecast sales and increases the complexity of our business. Since our distributors act as intermediaries between us and the companies using our products, we must rely on our distributors to accurately report inventory levels and production forecasts. This arrangement requires us to manage a more complex supply chain and monitor the financial condition and credit worthiness of our distributors and customers. Our failure to manage one or more of these challenges could result in excess inventory or shortages that could seriously impact our operating revenue or limit the ability of companies using our semiconductors to deliver their products.

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

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

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

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

We are building some products on a customer owned tooling basis, also known in the semiconductor industry as COT, where we directly contract the manufacture of wafers and assume the responsibility for the assembly and testing of our products. As a result, we are subject to increased risks arising from wafer manufacturing yields and risks associated with coordination of the manufacturing, assembly and testing process. Poor product yields would result in higher product costs, which could make our products uncompetitive with products offered by our competitors, thereby resulting in low gross profit margins or loss of revenue, or both.

We are dependent on our foundries to implement complex semiconductor technologies, which could adversely affect our operations if those technologies are not available, delayed or inefficiently implemented.

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

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

Semiconductor manufacturing technologies change rapidly and manufacturers typically discontinue older manufacturing processes in favor of newer ones. Once a manufacturer makes the decision to retire a manufacturing process, notice is generally given to its customers. Customers will then either retire the affected part or develop a new version of the part that can be manufactured on the newer process. In the event that a manufacturing process is discontinued, our products could become unavailable from our current suppliers. Additionally, migrating to a new, more advanced process requires significant expenditures for research and development. A significant portion of our products use 0.25um embedded DRAM technology and the required manufacturing process for these technologies will likely be available for the next two years. We also utilize a 0.18um standard logic process, which we expect will be readily available for the next five to seven years. We have commitments from our suppliers to notify us in the event of a discontinuance of a manufacturing process in order to assist us with product transitions.

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

None of our products are fabricated by more than one supplier. Additionally, our products require manufacturing with state-of-the-art fabrication equipment and techniques. Because the lead-time needed to establish a relationship with a new contract manufacturer is at least six months, and the estimated time for us to adapt a product’s design to a particular contract manufacturer’s processes is at least four months, there is no readily available alternative source of supply for any specific product. This could cause significant delays in shipping products, which may result in lost revenues and damaged customer relationships.

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

Our future success depends upon the continued services of our executive officers, key hardware and software engineers, and sales, marketing and support personnel, many of whom would be difficult to replace. The loss of one or more of these employees, particularly Allen Alley, our President and Chief Executive Officer, could seriously harm our business. In addition, because of the highly technical nature of our business, the loss of key engineering personnel could delay product introductions and significantly impair our ability to successfully create future products. We believe our success depends, in large part, upon our ability to identify, attract and retain qualified hardware and software engineers, and sales, marketing, finance and managerial personnel. Competition for talented personnel is intense and we may not be able to retain our key personnel or identify, attract or retain other highly qualified personnel in the future. We have experienced, and may continue to experience, difficulty in hiring and retaining employees with appropriate qualifications. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenues and business could be seriously harmed.

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

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

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

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

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

We develop products based on anticipated market and customer requirements and incur substantial product development expenditures, which can include the payment of large up-front, third-party license fees and royalties, prior to generating associated revenues. Because the development of our products incorporates not only our complex and evolving technology, but also our customers' specific requirements, a lengthy sales process is often required before potential customers begin the technical evaluation of our products. Our customers typically perform numerous tests and extensively evaluate our products before incorporating them into their systems. The time required for testing, evaluation and design of our products into a customer's equipment can take up to six months or more. It can take an additional six months before a customer commences volume shipments of systems that incorporate our products. However, even when we achieve a design win, the customer may never ship systems incorporating our products. We cannot assure you that the time required for the testing, evaluation and design of our products by our customers would not exceed six months. Because of this lengthy development cycle, we will experience delays between the time we incur expenditures for research and development, sales and marketing, inventory levels and the time we generate revenues, if any, from these expenditures. Additionally, if actual sales volumes for a particular product are substantially less than originally forecasted, we may experience large write-offs of capitalized license fees, product masks and prepaid royalties that would negatively affect our operating results.

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

Shortages of components and other materials that are critical to the design and manufacture of our customers' products could limit our sales. These components include liquid crystal display panels and other display components, analog-to-digital converters, digital receivers and video decoders. During 2000, some of our customers experienced delays in the availability of key components from other suppliers, which, in turn, caused a delay in demand for the products that we supplied to our customers.

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

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

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

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

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

The markets in which we compete or seek to compete are subject to rapid technological change, frequent new product introductions, changing customer requirements for new products and features, and evolving industry standards. The introduction of new technologies and the emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Recent examples of changing industry standards include the introduction of high-definition television, or HDTV, new digital receivers and displays with resolutions that have required us to accelerate development of new products to meet these new standards.

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

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

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

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

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

Most of our current manufacturers and customers are located in China, Japan, Korea and Taiwan. The risk of earthquakes in the Pacific Rim region is significant due to the proximity of major earthquake fault lines in the area. A current manufacturer’s facilities were affected by a significant earthquake in Taiwan in September 1999. As a consequence of this earthquake, the manufacturer suffered power outages and disruption that impaired its production capacity. Earthquakes, fire, flooding and other natural disasters in the Pacific Rim region, or political unrest, labor strikes or work stoppages in countries where our manufacturers and customers are located likely would result in the disruption of our foundry partners' assembly capacity. Any disruption resulting from extraordinary events could cause significant delays in shipments of our solutions until we are able to shift our manufacturing or assembling from the affected contractor to another third-party vendor. There can be no assurance that alternative capacity could be obtained on favorable terms, if at all.

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

We may become subject to claims involving patents or other intellectual property rights. For example, in early 2000, we were notified by InFocus Corporation ("InFocus") that we were infringing on patents held by InFocus. In February 2000, we entered into a license agreement with InFocus granting us the right to use the technology covered by the InFocus patents. As a result, we recorded a one-time charge of $4,078 for patent settlement expense in the first quarter of 2000. Intellectual property claims could subject us to significant liability for damages and invalidate our proprietary rights. In addition, intellectual property claims may be brought against customers that incorporate our products in the design of their own products. These claims, regardless of their success or merit and regardless of whether we are named as defendants in a lawsuit, would likely be time-consuming and expensive to resolve and would divert the time and attention of management and technical personnel. Any future intellectual property litigation or claims also could force us to do one or more of the following:

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

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

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

Our ability to compete effectively with other companies will depend, in part, on our ability to maintain the proprietary nature of our technology, including our semiconductor designs and software. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods to protect our proprietary technologies. We hold 9 U.S. patents and have 40 patent applications pending with the U.S. Patent and Trademark

Office for protection of our significant technologies. In addition to filing patents in the U.S., we have applied for and have been granted 7 patents in Canada. We cannot assure you that the degree of protection offered by patents or trade secret laws will be sufficient. Furthermore, we cannot assure you that any patents will be issued as a result of any pending applications, or that, if issued, any claims allowed will be sufficiently broad to protect our technology. In addition, it is possible that existing or future patents may be challenged, invalidated or circumvented. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. In addition, we provide the computer programming code for our software to selected customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software.

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

To date, we acquired Panstera, Inc. in January 2001, nDSP in January 2002 and Jaldi Semiconductor in September 2002. In March 2003, we announced the execution of a definitive merger agreement with Genesis Microchip, Inc., however, the merger was terminated in August of 2003, and we incurred $8,949 of expenses related to the transaction. Additionally, in the third quarter of 2003, we made an investment of $10,000 in Semiconductor Manufacturing International Corporation (SMIC). We intend to continue to consider investments in or acquisitions of complementary businesses, products or technologies.

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

These and any future acquisitions and investments could result in:

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

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

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

We may not be able to successfully integrate businesses, products, technologies or personnel that we might acquire in the future and any failure to do so could disrupt our business and seriously harm our financial condition.

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

As of March 31, 2004, goodwill amounted to $82,548, or approximately 33%, of our total assets. Effective January 1, 2002 with the adoption of new accounting standards the Company is required to review goodwill for possible impairment on an annual basis or when events and circumstances arise which indicate a possible impairment. The review of goodwill for impairment may result in large write-offs of goodwill, which could have a material adverse effect on our results of operations.

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

Our ability to successfully market and sell our products in a rapidly evolving market requires effective planning and management processes. We continue to increase the scope of our operations domestically and internationally and have increased our headcount substantially. Through internal growth as well as acquisition, our headcount grew from 176 employees at the end of 2001 to 257 at March 31, 2004. Our past growth, and our expected future growth, places a significant strain on our management systems and resources including our financial and managerial controls, reporting systems and procedures. To manage our growth effectively, we must implement and improve operational and financial systems, train and manage our employee base and attract and retain qualified personnel with relevant experience. We must also manage multiple relationships with customers, business partners, contract manufacturers, suppliers and other third parties. Moreover, we will spend substantial amounts of time and money in connection with our rapid growth and may have unexpected costs. Our systems, procedures or controls may not be adequate to support our operations and we may not be able to expand quickly enough to exploit potential market opportunities. While we have not, to date, suffered any significant adverse consequences due to our growth, if we do not continue to manage growth effectively our operating expenses could increase more rapidly than our revenue causing decreased profitability.

RISKS RELATED TO OUR INDUSTRY

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

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

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

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

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

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

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

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

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

OTHER RISKS

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

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

- Our board of directors is authorized, without prior stockholder approval, to create and issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us or change our control, commonly referred to as ‘‘blank check’’ preferred stock.
- Members of our board of directors can only be removed for cause.
- The board of directors may alter our bylaws without obtaining shareholder approval.
- Shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting.

Our principal shareholders have significant voting power and may take actions that may make it more difficult to sell our shares at a premium to take over candidates.

Our executive officers, directors and other principal shareholders, in the aggregate, beneficially own 5,512,780 shares or approximately 12% of our outstanding common stock as of April 30, 2004. These shareholders currently have, and will continue to have, significant influence with respect to the election of our directors and approval or disapproval of our significant corporate actions. This influence over our affairs might be adverse to the interest of our other shareholders. In addition, the voting power of these shareholders could have the effect of delaying or preventing a change in control of our business or otherwise discouraging a potential acquirer from attempting to obtain control of us, which could prevent our other shareholders from realizing a premium over the market price for their common stock.

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

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

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

In particular, the stock prices of technology companies similar to us have been highly volatile recently. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. Market fluctuations as well as general economic, political and market conditions including recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our common stock. Therefore, the price of our common stock may decline, and the value of your investment may be reduced regardless of our performance.

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

All of our sales are denominated in U.S. dollars and as a result, we have relatively little exposure to foreign currency exchange risk with respect to any of our sales. We have employees located in offices in Canada, China, Japan and Taiwan and as a result 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. The effect of an immediate 10% change in exchange rates would not have a material impact on our future operating results or financial position.

Item 4. Controls and Procedures

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

(b) *Changes in Internal Controls*. There have been no significant changes in our internal controls over financial reporting that could significantly affect those controls subsequent to the date of the evaluation, and no significant deficiencies or material weaknesses were identified which required corrective action.

PART II - OTHER INFORMATION

Item 6: Exhibits and Reports on Form 8-K

(a) Exhibits

10.1 Fifth Amendment to Lease dated February 18, 2004 between Pixelworks, Inc. and Quest Group Trust VI.

10.2 First Amendment to Sublease dated February 2004 between Pixelworks, Inc. and Epicor Software Corporation.

(b) Reports on Form 8-K

Reports Furnished

On January 7, 2004, we furnished a report on Form 8-K to report under Item 7 and 12 that on January 7, 2004 we issued a press release updating our business outlook for the quarter ending December 31, 2003.

On January 27, 2004, we furnished a report on Form 8-K to report under Item 7 and 12 that on January 27, 2004 we issued a press release announcing our financial results for the quarter and year ending December 31, 2003.

Reports Filed

On February 2, 2004, we filed a report on Form 8-K to report under Item 5 that on January 30, 2004 Bradley A. Zenger, Senior Vice President, Sales and Marketing, entered into a Rule 10b5-1 Plan with Citigroup Global Markets Inc. pursuant to which Citigroup will undertake to sell up to 320,000 shares of Pixelworks common stock owned by Mr. Zenger at specified intervals between February 9, 2004 and November 11, 2005.

SIGNATURES

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

PIXELWORKS, INC.

Dated: May 7, 2004

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

Exhibit 10.1

FIFTH AMENDMENT TO LEASE

THIS AGREEMENT, dated for reference purpose only, February 18, 2004, is made by and between Union Bank of California, N.A., as Successor in interest to Copper Mountain Trust Corporation, Trustees, for **Quest Group Trust VI** ("Landlord"), and **Pixelworks, Inc., an Oregon Corporation** ("Tenant").

RECITALS:

A. The parties hereto entered into a Lease dated May 1, 1998, and amended by Addendum A dated May 1, 1998 and First Amendment to Lease dated August 11, 2000, and Second Amendment to Lease dated January 24, 2001, Third Amendment to Lease dated March 1, 2002, and Fourth Amendment dated June 23, 2004 (the "Lease"), for certain real property commonly known as Suite 207, 4,671 rentable square feet, Suite 111, 997 rentable square feet, Suite 110, 1,742 rentable square feet, Suite 107, 1,910 rentable square feet, Suite 105, 1,374 rentable square feet, and Suite 100, 3,029 rentable square feet, for a total of 13,696 rentable square feet, known as the "Premises", located in Lakeside Center, a Class A office building described as 8100 S.W. Nyberg Road, Tualatin, Oregon 97062.

B. The parties desire to amend certain provisions thereof.

NOW, THEREFORE, the parties hereto hereby agree as follows:

1. **Expansion Space.** Effective March 1, 2004 Tenant shall lease an additional 3,857 rentable square feet, known as Suites 201 (2,107 rsf) and 210 (1,380 rsf) plus an additional 370 rentable square feet of corridor. Lease term shall be co-terminus with existing Premises. Tenant's total square footage shall be 17,553 rsf.

2. **Lease Extension.** Effective October 1, 2004, Tenant and Landlord agree to extend the lease term for an additional 52 months, through February 28, 2009.

3. **Base Rent Schedule:**

   Rent for the additional 3,857 rsf shall start at $21.00 per square foot through 12/31/05 with three percent bumps beginning January, 2006.

03/01/04 – 03/31/04 *	$28,484.00 per month	($19.47/sf/yr)
04/01/04 – 09/30/04	$31,859.00 per month	($21.78/sf/yr)
10/01/04 – 12/31/05	$31,664.00 per month	($21.67/sf/yr)
01/01/06 – 12/31/06	$32,613.00 per month	($22.32/sf/yr)
01/01/07 – 12/31/07	$33,591.00 per month	($22.99/sf/yr)
01/01/08 – 02/28/09	$34.598.00 per month	($23.68/sf/yr)

Tenant paying half month's rent ($3,375) on 3,857 rsf for the month of March, 2004.

4. **Tenant Improvements.** Landlord will provide Tenant a tenant improvement allowance of $123,894.00 to be applied toward the cost associated with the attached (Exhibit A) tenant improvement plans for floors one, two and four. Tenant is solely responsible for any tenant improvement cost beyond Landlord's tenant improvement allowance. Landlord approves of Tenant's Tenant improvement plan (Exhibit A) with the following qualifications:

   A. Any tenant improvement construction work must be performed by a contractor signatory to the appropriate collective bargaining agreement. All tenant improvements have been approved by all appropriate City and County inspectors.

   B. Tenant shall provide Landlord a payment of $9,500.00 at the end of the Lease Term (or upon vacation of Suite 100) to remove bathroom/showers in Suite 100. Tenant agrees to remove bike racks(s) in Suite 100 at the end of Lease Term or upon vacation of Suite 100.

   C. Tenant agrees to remove all accordion doors and repair ceiling grid (if needed) located in Suites 105/111 and in area known as Suite 200 at the end of the Lease Term or upon vacation of the Premises.

D. Second Floor corridor shall be restored upon the end of the Lease term or upon Tenant's vacation of the Premises. Fourth floor also requires one-hour fire walls around elevators as provided for on the third floor.

E. Tenant will provide Landlord with updated floor plans in CAD format upon completion of tenant improvements.

5. Tenant's base year for operating expenses for the Premises shall be calendar year 2004. Prorata share of operating expenses for the Premises shall be 31.65%.

6. Landlord does not pay a broker fee on the Premises lease extensions. Landlord will pay a 5% fee to Integrated Corporate Property Services for the expansion space in Suites 201 and 210 and corridor (3,857 rsf).

7. As amended by this Fifth Amendment to Lease, the Lease shall remain in full force and effect, including all items in the Fourth Amendment to Lease now signed.

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

LANDLORD:
Union Bank of California, N.A., as Trustee
for Quest Group Trust VI

By: ______________________________
Tim West, Vice President

Date: ______________________________

TENANT:
Pixelworks, Inc., an Oregon Corporation

By: ______________________________
Hans Olsen, Executive Vice President

Date: ______________________________

Exhibit 10.2

FIRST AMENDMENT TO LEASE

THIS FIRST AMENDMENT TO LEASE ("Agreement") is made and entered into this day of February, 2004 between **EPICOR SOFTWARE CORPORATION**, a Delaware corporation ("Sublandlord") and **PIXELWORKS, INC**., an Oregon corporation ("Subtenant").

WHEREAS, by Lease Agreement dated October 6, 1995, **COPPER MOUNTAIN TRUST CORPORATION AS TRUSTEE FOR QUEST GROUP TRUST VI** ("Landlord") leased to Sublandlord, on a full service basis, office space (the "Premises") consisting of a portion of the building commonly known as Lakeside Center located at 8100 SW Nyberg Road, Tualatin, Oregon 97062 (the "Building"), as amended by that certain Addendum to the Lease dated October 1, 1995, that certain Addendum A dated March 15, 1999, that certain Second Amendment dated December 13, 2000, and that certain Third Amendment dated February 2, 2001, and that certain Third [*sic* Fourth] Amendment dated August 20, 2001 (collectively, the "Master Lease", attached hereto and made a part hereof as Exhibit A). The Master Lease expires on February 28, 2006. Unless otherwise indicated herein, the terms defined in the Lease Agreement shall have the same meanings when used herein; and

WHEREAS, Sublandlord and Subtenant did enter into a certain sublease agreement dated September 7th, 2001 (the "Subease Agreement") under the terms of which Subtenant is currently leasing from Sublandlord approximately 14,679 rentable square feet consisting of the entire third floor of the Building (the "Original Premises"). Unless otherwise indicated herein, the terms defined in the Sublease Agreement shall have the same meanings when used herein; and

WHEREAS, Subtenant, pursuant to Section 9 of the Sublease Agreement, has exercised its option to expand the Original Premises ("Option to Expand") to include Sublandlord's premises on the second floor of the Building (Suite 203) consisting of 2,870 rentable square feet (the "Second Floor Expansion Premises") and Sublandlord's premises on the fourth floor of the Building (Suite 400) consisting of 14,679 square feet (the "Fourth Floor Expansion Premises"; collectively, the "Expansion Premises");

NOW, THEREFORE, in consideration of the Expansion Premises and mutual covenants and conditions contained herein, it is hereby agreed that the Sublease Agreement shall be, and is hereby amended as follows:

1. Expansion Premises. Subject to the terms and conditions of this First Amendment and the Sublease Agreement, Sublandlord hereby subleases to Subtenant and Subtenant hereby subleases from Sublandlord a portion of the Premises consisting of a portion of the second floor and the entire fourth floor of the Building as more particularly shown in Exhibit A attached hereto and made a part hereof (the "Expansion Premises"). The size of the Sublease Premises shall be amended to 32,228 rentable square feet.

2. Expansion Premises Term and Commencement. The term of for the Expansion Premises shall be approximately twenty-two (22) months in length with a commencement date of May 5, 2004 ("Expansion Effective Date") and a fixed expiration date of February 28, 2006.

3. Delivery and Possession.

(a) Fourth Floor Expansion Premises. Sublandlord shall deliver the Fourth Floor Expansion Premises to Subtenant on the Expansion Effective Date. Further, Subtenant shall not be allowed any early access to the Fourth Floor Expansion

Premises (in contrast to the Original Premises as described in paragraph 2 of the Sublease Agreement), provided however, that Sublandlord, upon reasonable advance notice from Subtenant to Sublandlord, agrees to make the Fourth Floor Expansion Premises reasonably accessible to Subtenant and Subtenant's employees and agents so that Subtenant may make arrangements for it use of the Fourth Floor Expansion Premises.

(b) Second Floor Expansion Premises. Sublandlord shall deliver the Second Floor Expansion Premises to Subtenant on the later of the date of full execution of this Agreement and the date written approval of this Agreement is received from Landlord. Regardless of the actual date of Subtenant's occupancy of the Second Floor Expansion Premises, Subtenant shall not be required to pay rent on any of the Expansion Premises prior to May 5, 2004.

4. Base Rent. The Base Rent schedule contained in paragraph 5 of the Sublease Agreement shall be amended as follows:

Months	Annual Base Rent/SF	Base Rent/Month
May 5, 2004 – December 31, 2004:	$ 23.20	$ 62,307.00
January 1, 2005 – February 28, 2006:	$ 24.00	$ 64,456.00

5. Operating Expenses and Taxes. Paragraph 6 of the Sublease Agreement shall be amended to state that Subtenant's "proportionate share" of Operating Expenses is 58.16%.

6. Leasehold Improvements. Sublandlord shall not be required to provide a tenant improvement allowance for the Expansion Premises.

7. Security Deposit. On or prior to the Expansion Delivery Date, Subtenant shall submit to Sublandlord an additional security deposit of $33,928.06 for a total security deposit of $59,861.07.

8. Brokerage Commissions. Sublandlord shall not be required to pay a brokerage commission to any party for representing Subtenant in connection with this First Amendment or the leasing of the Expansion Premises. Subtenant warrants that it has dealt with no real estate broker or agent in connection with this Sublease Agreement and Subtenant agrees to indemnify and hold Sublandlord harmless from any cost, expense or liability (including reasonable attorneys' fees) for any compensation, commission or charges claimed by any other real estate broker or agent employed or claiming to represent or to have been employed by Subtenant in connection with the negotiation of this Sublease Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement to be effective the day and year first above written.

AGREED AND ACCEPTED:

SUBLANDLORD:

EPICOR SOFTWARE CORPORATION

By: ______________________________

Title: ______________________________

Date: ______________________________

SUBTENANT:

PIXELWORKS, INC.

By: ______________________________

Title: ______________________________

Date: ______________________________

Exhibit 31.1

CERTIFICATION

I, Allen H. Alley, certify that:

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

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

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

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) 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. 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

    c. 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 that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

Date: May 7, 2004

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

Exhibit 31.2

CERTIFICATION

I, Jeffrey B. Bouchard, certify that:

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

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

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

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) 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. 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

   c. 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 that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

Date: May 7, 2004

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

Exhibit 32.1

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

In connection with the Quarterly Report of Pixelworks, Inc. (the "Company") on Form 10-Q for the three months ended March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Allen H. Alley, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

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

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

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

Date: May 7, 2004

Exhibit 32.2

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

In connection with the Quarterly Report of Pixelworks, Inc. (the "Company") on Form 10-Q for the three months ended March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jeffrey B. Bouchard, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

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

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

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

Date: May 7, 2004