PIXELWORKS INC
Form 10-Q/A
August 19, 2003

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q/A

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

**For the quarterly period ended June 30, 2003**

**OR**

**o 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 ý No o

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

Number of shares of Common Stock outstanding as of July 31, 2003: 44,609,617

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**PIXELWORKS, INC.**

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EXPLANATORY NOTE

THIS AMENDMENT ON FORM 10-Q/A IS BEING FILED TO INCLUDE THE INFORMATION REQUIRED BY ITEM 4 OF PART II OF FORM 10-Q. FOR THE CONVEINANCE OF THE READER, WE HAVE INCLUDED OUR ENTIRE QUARTERLY REPORT ON FORM 10-Q.

## PART 1 - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

**PIXELWORKS, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(In thousands)**

| | June 30, 2003 (Unaudited) | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 88,760 | $ 62,152 |
| Short-term marketable securities | 13,051 | 24,915 |
| Accounts receivable, net | 10,230 | 10,421 |
| Inventories, net | 9,722 | 6,788 |
| Prepaid expenses and other current assets | 4,215 | 3,896 |
| Total current assets | 125,978 | 108,172 |
| Long-term marketable securities | 4,089 | 14,500 |
| Property and equipment, net | 8,502 | 9,073 |
| Goodwill | 82,548 | 82,548 |
| Acquired intangible assets | 5,133 | 5,882 |
| Other assets | 6,518 | 7,037 |
| Total assets | $ 232,768 | $ 227,212 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $ 7,030 | $ 5,084 |
| Accrued liabilities and other liabilities | 9,154 | 7,312 |
| Total current liabilities | 16,184 | 12,396 |
| Shareholders equity: | | |
| Common stock | 289,986 | 287,566 |
| Shares exchangeable into common stock | 8,119 | 10,491 |
| Deferred stock compensation | (1,350) | (2,402) |

| | | | | |
|---|---|---|---|---|
| Accumulated deficit | | | (80,171) | (80,839) |
| Total shareholders equity | | | 216,584 | 214,816 |
| Total liabilities and shareholders equity | | $ | 232,768 | $ 227,212 |

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

**PIXELWORKS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(Unaudited)**

**(In thousands, except per share data)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Revenue | $ 32,559 | $ 24,644 | $ 64,564 | $ 46,649 |
| Cost of revenue (inclusive of amortization of deferred stock compensation of $2, $5, $5 and $11 for the three and six months ended June 30, 2003 and 2002, respectively) | 17,880 | 12,266 | 35,172 | 22,810 |
| Gross profit | 14,679 | 12,378 | 29,392 | 23,839 |
| | | | | |
| Operating expenses: | | | | |
| Research and development(1) | 6,250 | 5,275 | 12,344 | 10,727 |
| Selling, general and administrative(2) | 6,093 | 5,839 | 12,134 | 11,027 |
| Amortization of assembled workforce | 242 | | 485 | |
| In-process research and development expense | | | | 4,200 |
| Amortization of deferred stock compensation | 226 | 170 | 388 | 1,191 |
| Merger-related expenses | 1,398 | | 2,977 | |
| Total operating expenses | 14,209 | 11,284 | 28,328 | 27,145 |
| Income (loss) from operations | 470 | 1,094 | 1,064 | (3,306) |
| | | | | |
| Interest income | 305 | 617 | 690 | 1,292 |
| Interest expense | (4) | (23) | (10) | (54) |
| Interest income, net | 301 | 594 | 680 | 1,238 |
| Income (loss) before income taxes | 771 | 1,688 | 1,744 | (2,068) |
| | | | | |
| Provision for income taxes | 351 | 327 | 1,076 | 478 |
| | | | | |
| Net income (loss) | $ 420 | $ 1,361 | $ 668 | $ (2,546) |
| | | | | |
| Net income (loss) per share: | | | | |
| Basic and diluted | $ 0.01 | $ 0.03 | $ 0.01 | $ (0.06) |

| | | | | |
|---|---|---|---|---|
| Weighted average shares used in computing net income (loss) per share: | | | | |
| Basic | 45,184 | 42,804 | 45,106 | 42,613 |
| Diluted | 46,390 | 44,298 | 46,364 | 42,613 |

| | | | | |
|---|---|---|---|---|
| Amount excludes amortization of deferred stock compensation of: | | | | |
| (1) Research and development | $ 126 | $ 42 | $ 436 | $ 790 |
| (2) Selling, general and administrative | 100 | 128 | (48) | 401 |

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

**PIXELWORKS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

**(In thousands)**

| | Six Months Ended June 30, | |
|---|---|---|
| | **2003** | **2002** |
| Cash flows from operating activities: | | |
| Net income (loss) | $ 668 | $ (2,546) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activites: | | |
| Depreciation and amortization | 3,137 | 2,781 |
| Loss on disposal of assets | | 87 |
| Amortization of assembled workforce | 485 | |
| Amortization of developed technology | 264 | 220 |
| Amortization of deferred stock compensation | 393 | 1,202 |
| In-process research and development expense | | 4,200 |
| Changes in operating assets and liabilities, net of assets acquired: | | |
| Accounts receivable | 191 | (1,608) |
| Inventories | (2,934) | (54) |
| Prepaid expenses and other current and long-term assets | (190) | (1,729) |
| Accounts payable | 1,946 | (969) |
| Accrued liabilities | 1,992 | (1,166) |
| Net cash provided by operating activities | 5,952 | 418 |
| | | |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (2,023) | (3,450) |
| Purchases of other assets and investments | (153) | (912) |
| Acquisition, net of cash acquired | | (1,541) |
| Purchase of marketable securities | (16,025) | (21,880) |
| Maturities of marketable securities | 38,300 | 27,025 |
| Net cash provided by (used in) investing activities | 20,099 | (758) |
| | | |
| Cash flows from financing activities: | | |
| Payments on long-term debt | (150) | (394) |
| Proceeds from issuances of common stock | 707 | 806 |
| Net cash provided by financing activities | 557 | 412 |
| | | |
| Increase in cash and cash equivalents | 26,608 | 72 |
| Cash and cash equivalents at beginning of period | 62,152 | 53,288 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents at end of period | $ | 88,760 | $ | 53,360 |
| | | | | |
| Supplemental disclosure of cash flow information: | | | | |
| Interest paid | $ | 9 | $ | 53 |
| Taxes paid | | 256 | | 35 |
| Issuance of stock for acquisition of business | $ | | $ | 20,114 |

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

**PIXELWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**(In thousands, except per share data)**

**Note 1: Basis of Presentation**

The financial information included herein for the three and six months ended June 30, 2003 and 2002 is unaudited; however, such information reflects all adjustments consisting only of normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the three and six months ended June 30, 2003 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2003.

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

This report on Form 10-Q/A for the quarter ended June 30, 2003, should be read in conjunction with the Company s Annual Report on Form 10-K/A for the year ended December 31, 2002 filed on May 30, 2003. Portions of the accompanying financial statements are derived from the audited year-end financial statements of the Company for the year ended December 31, 2002.

**Stock Compensation**

Statement of Financial Accounting Standards ( SFAS ) No. 123, *Accounting for Stock-Based Compensation*, defines a fair value based method of accounting for an employee stock option or similar instrument. SFAS No. 123 allows an entity to continue to measure compensation cost using the intrinsic value based method of accounting prescribed by APB Opinion No. 25 ( Opinion 25 ), *Accounting for Stock Issued to Employees*. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Entities electing to continue applying the accounting treatment described in Opinion 25 must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair value based method had been applied. Pixelworks has elected to continue to apply the accounting prescribed in Opinion 25 and to make the disclosures required under SFAS No. 123.

Pixelworks accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force consensus on Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services*. There have been no equity instruments issued to non-employees during the periods presented.

The fair value of the options granted during the three and six months ended June 30, 2003 and 2002 was estimated at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **Stock Option Plans:** | **2003** | **2002** | **2003** | **2002** |
| Risk free interest rate | 2.49% | 2.78% | 2.89% | 2.78% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Expected life - years | 5.5 | 5.5 | 5.5 | 5.5 |
| Volatility | 110% | 115% | 113% | 115% |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **Employee Stock Purchase Plan (ESPP):** | **2003** | **2002** | **2003** | **2002** |
| Risk free interest rate | 1.91% | 1.89% | 1.84% | 4.32% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Expected life - years | 1.5 | 0.5 | 1.2 | 1.0 |
| Volatility | 105% | 90% | 101% | 106% |

Had Pixelworks accounted for its stock-based compensation plans in accordance with SFAS No. 123, Pixelworks net loss would approximate the pro forma disclosure as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Net income (loss): | | | | |
| As reported | $ 420 | $ 1,361 | $ 668 | $ (2,546) |
| Stock compensation expense, net of tax, as reported | 141 | 109 | 244 | 745 |
| Stock compensation expense, net of tax, under SFAS 123 | (2,272) | (1,953) | (4,450) | (4,171) |
| Pro forma net loss | $ (1,711) | $ (483) | $ (3,538) | $ (5,972) |
| | | | | |
| Basic and diluted net income (loss) per share: | | | | |
| As reported | $ 0.01 | $ 0.03 | $ 0.01 | $ (0.06) |
| Pro forma | (0.04) | (0.01) | (0.08) | (0.14) |

The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts and additional awards are anticipated in future years.

**Segments**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for disclosure about operating segments in annual financial statements and selected information in interim financial reports. Based on definitions contained within SFAS No. 131, the Company has determined that it operates within one segment, the design and marketing of integrated circuits for the advanced display industry. Substantially all of the assets of the Company are located in the United States.

**Geographic Information**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Japan | $ 11,303 | $ 12,278 | $ 26,177 | $ 21,381 |
| Taiwan | 9,846 | 3,674 | 15,964 | 8,426 |
| China | 3,982 | 1,843 | 6,004 | 3,107 |
| Korea | 3,625 | 2,990 | 8,673 | 5,989 |
| United States | 483 | 328 | 854 | 666 |
| Other countries | 3,320 | 3,531 | 6,892 | 7,080 |
| Total revenue | $ 32,559 | $ 24,644 | $ 64,564 | $ 46,649 |

**Significant Customers**

The following table shows percentage of total revenue by distributor for those distributors generating 10% or more of total revenue:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Distributor A | 31% | 47% | 37% | 43% |
| Distributor B | 19% | 9% | 15% | 11% |

During the three and six months ended June 30, 2003 and 2002 no end-customers represented more than 10% of total revenue. End customers represent customers who indirectly purchase the Company s products through distributors and contract manufacturers as well as directly from the Company.

The following table shows percentage of gross accounts receivable outstanding by account for those accounts representing 10% or more of total accounts receivable:

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| Account A | 20% | 48% |
| Account B | 25% | 16% |
| Account C | 12% | 2% |

Loss of or non-performance by these significant customers could adversely affect Pixelworks financial position or results of operations.

**Note 2: Earnings per share**

Basic earnings per share ( EPS ) is computed on the basis of the weighted average number of common shares outstanding. Diluted EPS is computed on the basis of the weighted average

common shares outstanding plus the effect of outstanding stock options using the treasury stock method and shares of restricted stock, if the potential common shares were not anti-dilutive.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Potential common stock equivalent shares related to stock options | | | | 1,680 |
| Shares of restricted stock subject to repurchase | | | | 56 |

Potential common stock equivalent shares related to stock options excludes weighted shares for which the options exercise price was greater than the average market price for the period of 4,338 and 3,006 for the three months ended June 30, 2003 and 2002, respectively and 4,198 and 2,483 for the six months ended June 30, 2003 and 2002, respectively.

The computation of basic weighted average shares outstanding includes exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 to former shareholders of Jaldi Semiconductor in an asset acquisition, are intended to have characteristics essentially equivalent to our common stock.

**Note 3: Balance Sheet Components**

**Inventories**

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

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| Finished goods | $ 8,083 | $ 5,249 |
| Work in process | 1,639 | 1,539 |
| | $ 9,722 | $ 6,788 |

**Warranty Reserve**

At the time revenue is recognized, we provide an accrual for estimated costs to be incurred pursuant to our warranty obligations. Our estimate is based primarily on our historical experience. The following table presents a roll forward of the reserve for warranty returns for the six months

ended June 30, 2003:

| | | |
|---|---|---|
| Balance at January 1, 2003 | $ | 769 |
| Provision | | (60) |
| Charge offs | | (105) |
| Balance at June 30, 2003 | $ | 604 |

**Note 4: Acquisitions**

**Jaldi Semiconductor Corp.**

On January 30, 2001, Pixelworks made an investment of $7,500 in Jaldi Semiconductor Corporation ( Jaldi ), a privately held development stage fabless semiconductor company based near Toronto in Richmond Hill, Ontario, Canada. On September 6, 2002, Pixelworks acquired the remaining equity interest in Jaldi in exchange for 1,731 shares exchangeable for Pixelworks common stock and the assumption of all outstanding stock options. The acquisition has been accounted for as an asset purchase and the results of Jaldi s operations have been included in the Company s financial statements beginning on September 6, 2002. Jaldi s technology is expected to expand Pixelworks product portfolio for the digital television market.

Under the terms of the reorganization agreement between Jaldi, Pixelworks, Inc. and Pixelworks Nova Scotia, a wholly-owned subsidiary of Pixelworks, each outstanding share of Jaldi was exchanged for .531727153 of a Jaldi exchangeable share. Holders of exchangeable shares have dividend, voting and other rights equivalent to common stockholders of Pixelworks. These exchangeable shares are the economic equivalent of common shares of Pixelworks and may be exchanged for those shares on a one-for-one basis at any time. The aggregate purchase price of Jaldi was approximately $24,988 consisting of 1,731 shares that are issuable upon the exchange of the Jaldi exchangeable shares that are valued at $16,376, the assumption of approximately 119 stock options valued at $1,011, and $7,601 cash (including the $7,500 investment in 2001). The estimated fair value of the shares issued was based on the average closing price of Pixelworks common stock on the day prior to the announcement of the intent to exercise the option to acquire Jaldi, the day of the announcement, and the day following the announcement ($9.46 per share).

The purchase price of this development stage company was derived as follows for accounting purposes:

| | Jaldi Shares | Total Pixelworks Common Shares | | Fair Value |
|---|---|---|---|---|
| Common shares | 3,256 | 1,731 | $ | 16,376 |
| Stock options | 224 | 119 | | 1,011 |
| | 3,480 | 1,850 | | 17,387 |
| | | | | |
| Cash investment in 2001 | | | | 7,500 |
| Acquisition costs | | | | 101 |
| Total purchase price | | | $ | 24,988 |

The purchase price was allocated to the assets and liabilities based on fair values as follows:

| | | |
|---|---|---|
| Assets acquired: | | |
| Current assets | $ | 2,084 |
| Non-current assets | | 2,111 |
| Acquired in-process research and development | | 20,142 |

| | | |
|---|---|---|
| Deferred compensation on unvested stock awards assumed | | 1,205 |
| Assembled workforce | | 2,909 |
| | | |
| Less: | | |
| Liabilities assumed | | (3,463) |
| | | |
| Allocated purchase price | $ | 24,988 |

The purchase price was allocated to assets acquired and liabilities assumed based on management s analysis and estimates of their fair values. Management s estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. The in-process research and development ( IPR&D ) and the assembled workforce were valued at $6,300 and $910, respectively. The remaining excess purchase price over the identifiable tangible and intangible net assets was $15,841 and was allocated on a pro-rata basis resulting in $1,999 of the excess purchase price being assigned to assembled workforce and $13,842 being assigned to IPR&D assets. The IPR&D was expensed at the date of the acquisition in accordance with FASB Interpretation No. 4 ( FIN 4 ), *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*.

The value assigned to IPR&D related to research projects for which technological feasibility had not been established and no future alternative uses existed. The fair value was determined using the income approach, which discounts expected future cash flows from projects under development to their net present value using a risk adjusted rate. Each project was analyzed to determine the technological innovations, which included; the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion. Future cash flows were estimated, taking into account the expected life cycles of the product and the underlying technology, relevant market sizes and industry trends. The estimated net cash flows from these products were based on management s estimates of related revenues, cost of goods sold, R&D costs, selling, general and administrative costs, income taxes and charges for the use of contributory assets. A discount rate of 22% was utilized based on the technology of the products, the stage of completion of the projects, the complexity of the development effort and the risks associated with reaching technological feasibility of the projects. The nature of the efforts to develop the in-process technology into commercially viable products principally related to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its design specification, including function, features and technical performance requirements.

Jaldi had two products under development at the acquisition date, contributing 70% and 30% of the total IPR&D value. The products under development were video processing semiconductors targeting the high-definition digital display markets. The development projects ranged from 70% to 90% complete. All development projects had expected completion dates within one year and an estimated aggregate cost to complete of $1,600. One product is currently in production and the other product is in the pre-production stage with lead customers.

**nDSP**

On January 14, 2002, the Company acquired 100% of the outstanding shares of nDSP, Inc. ( nDSP ). The results of nDSP s operations have been included in the Company s financial statements beginning on the date of acquisition. nDSP is a fabless semiconductor company involved in the development of video processing ICs for the advanced display market. nDSP, headquartered in California, also has offices in China. The acquisition of nDSP is expected to strengthen Pixelworks advanced video processing product and technology portfolio and enable the Company to compete in the analog CRT and digital TV market. nDSP s technologies complement the technology found in Pixelworks system-on-a-chip ICs.

The aggregate purchase price of nDSP was 1,186 shares of Pixelworks common stock valued at $20,114. The estimated fair value of the shares issued was based on the average closing price of Pixelworks common stock on the day prior to the announcement of the Agreement and Plan of Merger, the day of the announcement, and the day following the announcement ($16.96 per share).

The purchase price for accounting purposes was derived as follows:

| | nDSP Shares | Total Pixelworks Common Shares | Fair Value |
|---|---|---|---|
| nDSP Common | 6,534 | 20 | $ 337 |
| nDSP Series A preferred | 6,693 | 381 | 6,465 |
| nDSP Series B preferred | 6,119 | 785 | 13,312 |
| | 19,346 | 1,186 | 20,114 |
| | | | |
| Acquisition costs | | | 857 |
| | | | |
| Total purchase price | | | $ 20,971 |

The purchase price was allocated to the assets and liabilities based on fair values as follows:

| | | |
|---|---|---|
| Assets acquired: | | |
| Current assets | $ | 1,409 |
| Non-current assets | | 741 |
| Acquired in-process research and development | | 4,200 |
| Developed technology | | 3,700 |
| Goodwill | | 14,371 |
| | | |
| Less: | | |
| Liabilities assumed | | (3,450) |
| | | |
| Allocated purchase price | $ | 20,971 |

The goodwill is not expected to be deductible for tax purposes.

The purchase price was allocated to assets acquired and liabilities assumed based on management s analysis and estimates of their fair values. Management s estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. Of the $22,271 of acquired intangible assets, $3,700 was assigned to acquired developed technology with a seven year estimated remaining life and $4,200 was assigned to IPR&D assets that were expensed at the date of acquisition in accordance with FIN 4. The $14,371 of goodwill was assigned to the Company as a reporting unit. In addition, the Company recorded a deferred tax asset of approximately $6,200, subject to a full valuation allowance, related primarily to nDSP s net operating loss carry-forward, which will be offset against goodwill when utilized.

The value assigned to IPR&D related to research projects for which technological feasibility had not been established and no future alternative uses existed. The fair value was determined using the income approach, which discounts expected future cash flows from projects under development to their net present value using a risk adjusted rate. Each project was analyzed to determine the technological innovations included;

the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion. Future cash flows were estimated, taking into account the expected life cycles of the product and the underlying technology, relevant market sizes and industry trends. The estimated net cash flows from these products were based on management s estimates of related revenues, cost of goods sold, R&D costs, selling, general and administrative costs, income taxes and charges for the use of contributory assets. A discount rate was determined for each project based on the technology of the product. For the developed technology a discount rate of 35% was used. The in-process technology rates utilized ranged from 40% to 55% and were based

on the stage of completion of the project, the complexity of the development effort and the risks associated with reaching technological feasibility of the project. The nature of the efforts to develop the in-process technology into commercially viable products principally related to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its design specification, including function, features and technical performance requirements.

nDSP had three main product groups under development at the acquisition date, each contributing from 7% to 64% of the total IPR&D value. The projects under development were video processing ICs targeting the digital display and analog CRT television markets. The projects ranged from 20% to 80% complete. All projects had expected completion dates within one year and an estimated aggregate cost to complete of $2,500. Since the date of the acquisition two of the products in development have been completed and development of the third product is expected to be completed in the next twelve months.

**Note 5: Genesis Microchip Transaction**

On March 17, 2003, the Company announced the execution of a definitive merger agreement with Genesis Microchip. On August 5, 2003, the Company entered into an agreement terminating the merger agreement. Under the terms of the termination agreement, Pixelworks agreed to pay a termination fee of $5,500 to Genesis Microchip upon execution of the agreement. The termination fee will be recognized as an expense in the third quarter of 2003. During the three and six months ended June 30, 2003, the Company recognized merger-related expenses of $1,398 and $2,977, respectively.

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

***(All references to dollar amounts and shares are in thousands)***

This Form 10-Q/A contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as projects, believes, expects, anticipates, intends, estimates, should, will, similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. We believe that the expectations reflected in the forward-looking statements are reasonable but we cannot assure you those expectations will prove to be correct. You should not place undue reliance on the forward-looking statements contained in this Form 10-Q/A. Important factors that could cause the Company s actual results to differ materially from those expectations are disclosed in this Form 10-Q/A, including those provided under the heading Additional Factors That May Affect Future Results below and in the reports and other documents filed by Pixelworks with the Securities and Exchange Commission including our Annual Report on Form 10-K/A for the year ending December 31, 2002. If any of these risks or uncertainties materializes or any of these assumptions prove incorrect, the results of Pixelworks could differ materially from the expectations expressed or implied in these documents. The forward-looking statements contained in this Form 10-Q/A 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 filing.

**Overview**

We design, develop and market system-on-a-chip integrated circuits ( ICs ) and software for the advanced display industry. Our system-on-chip and software technology translates and optimizes video and computer graphics for display on a wide variety of electronic devices used in business and consumer markets, including multimedia projectors, flat-panel monitors and digital televisions. Our product line is used by the world s leading manufacturers of consumer electronics and computer display products to enhance image quality and ease of use.

We sell our products worldwide through a direct sales force and indirectly through distributors and manufacturers representatives. Distributors have been established in China, Europe, Japan and Taiwan. Sales to distributors represented 65% and 64% of total revenue for the six months ended June 30, 2003 and 2002, respectively. Manufacturers representatives support some of our European and Korean sales. In addition to our Tualatin, Oregon corporate headquarters, we have facilities in California, Canada, China, Japan and Taiwan.

We recognize revenue from product sales to direct customers upon shipment. Revenue from product sales to distributors is recognized upon shipment if the distributor has a firm sales commitment from an end customer. Pixelworks complies with the revenue recognition guidance summarized in Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*. Reserves for sales returns and allowances are recorded at the time of shipment.

Historically, significant portions of our product revenue have been from a relatively small number of customers and distributors. Our top five end customers accounted for 34% and 42% of total revenue for the six months ended June 30, 2003 and 2002, respectively.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for 99% of total revenue for the six months ended June 30, 2003 and 2002. Our end customers, branded manufacturers and integrators, incorporate our products into systems that are sold worldwide. All revenue to date has been denominated in U.S. dollars.

**Acquisitions**

On January 30, 2001, Pixelworks made an investment of $7,500 in Jaldi Semiconductor Corporation ( Jaldi ), a privately held development stage fabless semiconductor company based near Toronto in Richmond Hill, Ontario, Canada. On September 6, 2002, Pixelworks acquired the remaining equity interest in exchange for approximately 1,731 shares exchangeable for Pixelworks common stock and the assumption of all outstanding stock options. The acquisition was recorded as an asset purchase and the results of Jaldi s operations are included in the Company s financial statements beginning on the date of acquisition. The Company incurred a charge of $20,142 in the third quarter of 2002 for purchased IPR&D related to the acquisition. Jaldi had two products under development at the acquisition date, contributing 70% and 30% of the total IPR&D value. The products under development were video processing semiconductors targeting the high-definition digital display markets. The development projects ranged from 70% to 90% complete. Both projects had expected completion dates within one year and an estimated aggregate cost to complete of $1,600. One product is currently in production and the other product is in the pre-production stage with lead customers.

On January 14, 2002, we acquired all of the outstanding shares of nDSP, Inc. ( nDSP ) in exchange for approximately 1,186 shares of Pixelworks stock. nDSP was a privately held fabless semiconductor company providing video processing ICs designed to enhance the picture quality of televisions, flat panel displays and multimedia projectors. The transaction was accounted for by

the purchase method of accounting, and accordingly, the results of operations of nDSP, Inc. are included in the Company s financial statements beginning on the date of acquisition. Pixelworks recorded a one-time charge of $4,200 in the first quarter of 2002 for IPR&D related to the acquisition. At the time of the acquisition nDSP had one product line in production and three main product lines under development, each contributing from 7% to 64% of the total IPR&D value. The products under development were video processing ICs targeting the digital display and analog CRT television markets. The products ranged from 20% to 80% complete with expected completion dates within one year and an estimated aggregate cost to complete of $2,500. Since the date of the acquisition two of the products in development have been completed and development of the third product is expected to be completed in the next twelve months.

**Results of Operations**

Three Months Ended June 30, 2003 Compared to Three Months Ended June 30, 2002

Revenue. Revenue for the three months ended June 30, 2003 increased to $32,559 from $24,644 for the three months ended June 30, 2002, a 32% increase. This increase resulted from a 58% increase in units shipped offset in part by a 16% decline in average selling prices. Revenue from shipments to multimedia projector manufacturers, which represented 51% of total revenue for the three months ended June 30, 2003, increased $2,786, or 20%. The increase was related to growth in the overall multimedia projector market, and in large part due to growth in shipments to projector manufacturers in Japan. Revenue from shipments to LCD monitor manufacturers, which represented 22% of total revenue for the three months ended June 30, 2003, increased $862, or 14%. The increase resulted from a 45% increase in unit shipments being partially offset by a 21% decline in average selling prices. The unit growth was primarily attributable to an increase in shipments to manufacturers UXGA-resolution monitors and LCD smart panel manufacturers. Smart panels represent an alternative to the traditional method for assembling an LCD monitor in which the LCD manufacturer integrates the image processing electronics onto the LCD panel before being sold to an integrator for final assembly. Revenue from shipments to advanced television manufacturers, which represented 25% of total revenue for the three months ended June 30, 2003, increased $3,901, or 94%. This increase resulted from a 101% increase in unit shipments offset by a decline of approximately 3% in average selling prices. The increase in unit shipments was due to rapid growth in the overall advanced television industry, and in particular, an increase in shipments to LCD television and plasma display manufacturers. Aggregate average selling prices are influenced by the specific mix of product shipments and can therefore vary significantly when comparing periods. We expect aggregate average selling prices will decrease in most future periods. Revenue from sources other than multimedia projector, LCD monitor and advanced television manufacturers increased $366, or 70%.

Gross profit. Gross profit margin was 45% for the three months ended June 30, 2003 compared to 50% for the three months ended June 30, 2002, inclusive of amortization of acquired developed technology and deferred stock compensation. The reduction in gross profit margin was due to an intensely competitive environment that resulted in average selling prices declining at a more rapid rate than average product costs.

Research and development. Research and development expense, inclusive of amortization of deferred stock compensation, was $6,376 or 20% of total revenue for the three months ended June 30, 2003 compared to $5,317 or 22% of revenue

for the three months ended June 30, 2002. The increase in research and development expense resulted from an increase of $109 in compensation

expense primarily related to an increase in personnel resulting from our September 2002 acquisition of Jaldi and an increase of $1,092 in development-related expenses including NRE and outside services.

Selling, general and administrative. Selling, general and administrative expense, inclusive of amortization of deferred stock compensation, was $6,193 or 19% of total revenue for the three months ended June 30, 2003 which compared to $5,967, or 24% of total revenue for the three months ended June 30, 2002. The increase in expense resulted primarily from a $304 increase in compensation expense due to an increase in personnel, a $134 increase in rent expense resulting from leasing additional building space to support a greater number of employees, and a $105 increase in insurance. Partially offsetting these increases was a decrease of $243 in accounting and legal related expenses and $186 in trade show and travel expenses.

Amortization of assembled workforce. As of June 30, 2003, there was $2,182 in assembled workforce on the balance sheet as a result of the acquisition of Jaldi in September 2002. The assembled workforce is being amortized over an estimated life of 36 months at a quarterly rate of $242.

Amortization of deferred stock compensation. Stock compensation expense was $228 for the three months ended June 30, 2003, inclusive of $2 included in cost of sales, an increase of $53 from $175 for the three months ended June 30, 2002, inclusive of $5 included in cost of sales. The increase in expense primarily related to new options issued in the third quarter of 2002 as a result of the Jaldi acquisition. Amortization of the June 30, 2003 balance of $1,350 in deferred stock compensation is estimated to be $758 for the remainder of 2003 and $514 and $78 in 2004 and 2005, respectively.

Merger-related expenses. Merger-related expenses of $1,398 were incurred during the quarter ended June 30, 2003 related to the proposed merger with Genesis Microchip. The expenses incurred in the three months ended June 30, 2003 consist primarily of legal, financial printing, tax and accounting fees. On August 5, 2003, the Company entered into an agreement terminating the merger agreement. Under the terms of the termination agreement, Pixelworks agreed to pay a termination fee of $5,500 to Genesis Microchip upon the execution of the termination agreement. The termination fee and any additional expenses incurred will be expensed in the third quarter.

Interest income, net. Interest income, net consists of interest income and interest expense. Interest income, net decreased $293 to $301 for the three months ended June 30, 2003 from $594 for the three months ended June 30, 2002. This decrease was the result of lower yields on invested cash in the current period due to overall interest rates declining over the past year.

Provision for income taxes. The provision for income taxes for the three months ended June 30, 2003 increased to $351 from $327 for the three months ended June 30, 2002. The increase in the provision was primarily attributable to the

Company s increased income before taxes. The effective tax rate differs from the federal statutory rate primarily due to the following items; non-cash expenses recognized for book purposes that are not deductible for tax purposes and an increase in the Company s valuation allowance related to Jaldi s net operating losses and various tax credits. Due to the termination of the proposed merger with Genesis Microchip certain merger related expenses which were treated as non-deductible for tax purposes in the three months ended March 31, 2003 are now tax deductible. Therefore, the provision for income taxes for the three months ended June 30, 2003 has been reduced to record a provision for income taxes for the full six months ended June 30, 2003 that reflects this change in treatment.

Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2002

Revenue. Revenue for the six months ended June 30, 2003 increased to $64,564 from $46,649 for the six months ended June 30, 2002, a 38% increase. This increase resulted from a 68% increase in units shipped offset in part by an 18% decline in average selling prices. Revenue from shipments to multimedia projector manufacturers, which represented 55% of total revenue for the six months ended June 30, 2003, increased $8,811, or 33%. The increase was related to growth in the overall multimedia projector market, and in large part due to growth in shipments to projector manufacturers in Japan. Revenue from shipments to LCD monitor manufacturers, which represented 23% of total revenue for the six months ended June 30, 2003, increased $2,233, or 18%. The increase resulted from a 66% increase in unit shipments being partially offset by a 29% decline in average selling prices. The unit growth was primarily attributable to an increase in shipments to manufacturers of UXGA-resolution monitors and LCD smart panel manufacturers. Revenue from shipments to advanced television manufacturers, which represented 19% of total revenue for the six months ended June 30, 2003, increased $5,797, or 86%. This increase resulted from a 77% increase in unit shipments and an increase of approximately 5% in average selling prices. The increase in unit shipments was due to rapid growth in the overall advanced television industry, and in particular, an increase in shipments to plasma display and LCD television manufacturers, which have had higher average selling prices than products shipped to progressive scan CRT television manufacturers. Aggregate average selling prices are influenced by the specific mix of product shipments and can therefore vary significantly when comparing periods. We expect aggregate average selling prices will decrease in most future periods. Revenue from sources other than multimedia projector, LCD monitor and advanced television manufacturers increased $1,074, or 101%.

Gross profit. Gross profit margin was 46% for the six months ended June 30, 2003 compared to 51% for the six months ended June 30, 2002, inclusive of amortization of acquired developed technology and deferred stock compensation. The reduction in gross profit margin was due to an intensely competitive environment that resulted in average selling prices declining at a more rapid rate than average product costs.

Research and development. Research and development expense, inclusive of amortization of deferred stock compensation, was $12,780 or 20% of total revenue for the six months ended June 30, 2003 compared to $11,517 or 25% of revenue for the six months ended June 30, 2002. The increase in research and development expense resulted from an increase of $550 in compensation expense primarily related to an increase in personnel resulting from our September 2002 acquisition of Jaldi, an increase of $983 in development related expenses including NRE and outside services and an increase in software and equipment related expenses of $183. These increases in expense were partially offset by a $354 decrease in amortization of deferred stock compensation primarily due to the use of the accelerated method of amortization, which recognizes more compensation in earlier periods, and the cancellation of unvested stock options upon employee termination.

Selling, general and administrative. Selling, general and administrative expense, inclusive of amortization of deferred stock compensation, was $12,086 or 19% of total revenue for the six months ended June 30, 2003 which compared to $11,428, or 24% of total revenue for the six months ended June 30, 2002. The increase in expense resulted primarily from a $435 increase in compensation expense due to an increase in personnel, a $340 increase in rent expense

resulting from leasing additional building space to support a greater number of employees, and a $213

increase in insurance. Partially offsetting these increases was a decrease of $126 in accounting and legal related expenses and $238 in trade shows and travel expenses.

In-process research and development expense. In-process research and development expense ( IPR&D ) for the six months ended June 30, 2002, which resulted from the acquisition of nDSP, was $4,200. IPR&D expense represents the discounted future cash flows from research and development projects in development, but not yet completed, at the time of our acquisition of nDSP. There was no IPR&D expense for the six months ended June 30, 2003.

Amortization of deferred stock compensation. Stock compensation expense was $393 for the six months ended June 30, 2003, inclusive of $5 included in cost of sales, a decrease of $809 from $1,202 for the six months ended June 30, 2002, inclusive of $11 included in cost of sales. The decrease was due primarily to the use of the accelerated method of amortization, which recognizes more compensation expense in earlier periods. The decrease was partially offset by an increase in expense related to new options issued in the third quarter of 2002 as a result of the Jaldi acquisition.

Merger-related expenses. Merger-related expenses of $2,977 were incurred during the six months ended June 30, 2003 related to the proposed merger with Genesis Microchip. The expenses incurred in the six months ended June 30, 2003 consist primarily of legal, investment banking, financial printing, tax and accounting fees.

Interest income, net. Interest income, net consists of interest income and interest expense. Interest income, net decreased $558 to $680 for the six months ended June 30, 2003 from $1,238 for the six months ended June 30, 2002. This decrease was primarily the result of lower yields on invested cash in the current period due to overall interest rates declining over the past year.

Provision for income taxes. The provision for income taxes for the six months ended June 30, 2003 increased to $1,076 from $478 for the six months ended June 30, 2002. The increase in the provision was primarily attributable to the Company s increased income before taxes. The effective tax rate differs from the federal statutory rate primarily due to the following items; non-cash expenses recognized for book purposes that are not deductible for tax purposes and an increase in the Company s valuation allowance related to Jaldi s net operating losses and various tax credits.

**Liquidity and Capital Resources**

As of June 30, 2003, the Company had cash and cash equivalents of $88,760 and working capital of $109,794 as compared to cash and cash equivalents of $62,152 and working capital of $95,776 as of December 31, 2002. Principal sources of cash during the six months ended June 30, 2003 were cash generated by operating activities of $5,952, roceeds from the issuance of stock under the Company s employee stock purchase plan and stock option plans of $707, and proceeds from the maturity of marketable securities net of purchases of marketable securities of $22,275. Principal uses of cash during the six months ended June 30, 2003 were debt payments of $150 and property and equipment

expenditures of $2,023.

Accounts Receivable. Accounts receivable decreased from $10,421 at December 31, 2002 to $10,230 at June 30, 2003, a decline of $191 or less than 2%. Average days sales outstanding ( DSO ) were 28 and 32 days at June 30, 2003 and December 31, 2002, respectively. The decrease in DSO and in total accounts receivable was primarily related to the timing of shipments

within the quarter with a smaller percentage of shipments occurring in the final month of the three months ending June 30, 2003 when compared to the three months ending December 31, 2002.

Inventories. Inventories increased $2,934 from $6,788 at December 31, 2002 to $9,722 at June 30, 2003. The increase was due to an increase of $2,834, or 54%, in finished goods inventory and an increase of $100, or 6%, in work in process inventory. Inventory turns were 7 and 11 at June 30, 2003 and December 31, 2002, respectively. Inventory turns of 7 represented approximately 7 weeks of shipments in inventory.

Capital Resources. As of June 30, 2003, principal commitments consisted of obligations outstanding under operating leases. These commitments include leases for approximately 52,000 square feet in two facilities located in Tualatin, Oregon, expiring through 2006 and two facilities in California for approximately 18,000 square feet. In September 2002, the Company added approximately 12,000 square feet in Ontario, Canada as a result of the acquisition of Jaldi. The total annual estimated costs for all leased property commitments are $2,547, $1,793, $1,076 and $289 for the years ending December 31, 2003, 2004, 2005 and 2006, respectively. As a result of the acquisition of nDSP, the Company assumed debt for equipment leases that as of June 30, 2003 represented approximately $62. All of the equipment lease payments are scheduled for payment over the next 12 months. Although the Company has no other material commitments, we may increase our capital expenditures in the future. In the future we may also require a larger inventory of products in order to support anticipated growth in our business.

On August 5, 2003, the Company entered into an agreement with Genesis Microchip to terminate the then pending merger agreement. Under the terms of the merger termination agreement, Pixelworks agreed to pay a termination fee of $5,500 to Genesis Microchip upon execution of the merger termination agreement. The termination fee will be paid in the third quarter of 2003.

The Company believes that its existing cash and cash equivalents and funds generated from operations will be sufficient to fund its operations for the next twelve months and the foreseeable future. From time to time, we may evaluate acquisitions of businesses, products or technologies that complement 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.

**Critical Accounting Policies and Estimates**

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. On an on-going basis, the Company evaluates its estimates, including those related to product returns, bad debts, inventories, prepaid expenses, intangible assets, income taxes, warranty obligations, litigation and other contingencies. Pixelworks bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Pixelworks believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

The Company records estimated reductions to revenue for customer returns based on historical experience. If actual customer returns increase, the Company may be required to recognize additional reductions to revenue.

The Company provides for the estimated cost of product warranties at the time revenue is recognized based on historical experience. Should actual product failure rates or product replacement costs differ from Pixelworks estimates, revisions to the estimated warranty liability would be required.

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of Pixelworks customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

The Company provides for a reserve against its inventory for estimated obsolescence or unmarketable inventory by calculating the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. Should Pixelworks determine that it would not be able to realize all or part of its 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.

**Recent Accounting Pronouncements**

In November 2002, the Emerging Issues Task Force reached a consensus on Issue No. 00-21 (EITF 00-21), *Revenue Arrangements with Multiple Deliverables.* EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 will be effective for interim periods beginning after June 15, 2003. The Company does not expect this issue to have a material impact on its consolidated financial position or results of operations.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The provisions of SFAS No. 149 will be effective for contracts entered into after June 30,2003. The Company does not expect that the adoption of SFAS No. 149 will have a material effect on its financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify certain instruments as liabilities (or assets in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective on July 1, 2003. The Company does not expect that the adoption of SFAS No. 150 will have a material effect on its financial position or results of operations.

**Additional Factors That May Affect Future Results**

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

**RISKS RELATED TO OUR OPERATIONS**

**While we have had quarterly periods of net income, we have incurred net losses on an annual basis since our inception and may not be able to achieve or sustain profitability on either a quarterly or annual basis in the future.**

While we had $668 of net income for the six months ended June 30, 2003, our accumulated deficit is $80,171 through June 30, 2003. 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 be profitable. We cannot be certain that we will be profitable in the future or, if we are, that we can sustain or increase profitability on a quarterly or annual basis. This may in turn cause the price of our common stock to decline. In addition, if we are not profitable in the future we may be unable to continue our operations.

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

Our quarterly operating results are likely to vary significantly in the future based on a number of factors related to our industry and the markets for our products, some of which are not in our control and any of which may cause the price of our common stock to fluctuate. These factors include:

demand for multimedia projectors, flat panel monitors, advanced television displays and Internet appliances;

demand for our products and the timing of orders for our products;

the deferral of customer orders in anticipation of our new products or product enhancements or due to a reduction in our 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 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 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 have incurred additional costs due to customers returning potentially affected products and have been required to resell products from third parties in order to meet certain customer commitments. 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 devices designing our products into their systems. To achieve design wins we must define and deliver cost-effective, innovative and integrated semiconductors. Once a supplier s products have been designed into a system, the developer may be reluctant to change its source of components due to the significant costs associated with qualifying a new supplier. Accordingly, the failure on our part to obtain additional design wins with leading branded manufacturers or integrators, and to successfully design, develop and introduce new products and product enhancements could harm our business, financial condition and results of operations.

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

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

The development of our semiconductors, which incorporate mixed analog and digital signal processing, is highly complex. These complexities require that we employ advanced designs and

manufacturing processes that are unproven. Since commencing our operations, we have experienced increased development time and delays in introducing new products. We will not always succeed in developing new products or product enhancements nor do so in a timely manner. 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 that were formerly done in one location.

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

Successful development and timely introduction of new or enhanced products depends on a number of other factors, including but not limited to:

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

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

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

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

may result in customers selecting competitive products requiring less software integration.

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

We are and will continue to be dependent on a limited number of large distributors and customers for a substantial portion of our revenue. For the six months ended June 30, 2003, and year ended December 31, 2002, sales to distributors represented 65% and 68% of total revenue, respectively. For the six months ended June 30, 2003, and year ended December 31, 2002, sales to Tokyo Electron Device Limited, our distributor in Japan, represented 37% and 45% of total revenue, respectively. During the six months ended June 30, 2003, there were no end customers that represented 10% or more of total revenue. Sales to our top five end-customers represented approximately 34% and 41% for the six months ended June 30, 2003 and the year ended December 31, 2002, 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 June 30, 2003, we had three customers that represented more than 10% of our accounts receivable balance. The failure of these customers to pay these accounts receivable would result in a significant expense that would seriously harm our operating results and would reduce our cash flows in the period incurred.

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

Sales outside of the U.S. accounted for 99%, 98% and 91% of our total revenue for the six months ended June 30, 2003, and the years ended December 31, 2002 and 2001, respectively. Most of our customers are concentrated in China, Japan, Korea and Taiwan, with aggregate sales from those four countries accounting for 88% of total revenue for the six months ended June 30, 2003, and 83% of our total revenue for both of the years ended December 31, 2002 and 2001, respectively. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenues in future periods. In addition, customers who incorporate our products into their products sell them outside of the U.S., thereby exposing us indirectly to foreign risks. Additionally, 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 Asian financial crisis that occurred in 1998 which caused a devaluation in the currencies of Japan, Taiwan and Korea resulting in an increased cost of procuring our semiconductors;

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

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

political and economic instability;

reduced or limited protection of our intellectual property, significant amounts of which are contained in software which is more prone to design piracy;

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

increased transaction costs related to sales transactions conducted outside of the U.S. such as charges to secure letters of credit for foreign receivables;

difficulties in maintaining sales representatives outside of the U.S. that are knowledgeable of the display processor industry and our display processor products; and

difficulties in collecting accounts receivable.

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

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

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

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

If we are unable to obtain our products from manufacturers on schedule, our ability to satisfy customer demand will be harmed, and revenue from the sale of products may be lost or delayed. If orders for our products are canceled, expected revenues 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, or suffer declines in our gross margin.

**We use a COT, or customer-owned tooling, process for manufacturing some of our products which exposes us to the possibility of poor yields on manufactured products negatively impacting our gross profit margins and could also result in a reduction or loss of revenue.**

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 associated with coordination of the manufacturing, assembly and testing process. Failure to effectively use this approach to manufacturing would reduce our revenues and harm our gross margin and results of operations.

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

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

**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 three to five 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.**

Our products require manufacturing with state-of-the-art fabrication equipment and techniques. Because the lead-time needed to establish a relationship with a new contract manufacturer is at least six months, and the estimated time for us to adapt a product s design to a particular contract manufacturer s processes is at least four months, there is no readily available alternative source of supply for any specific product. This could cause significant delays in shipping products, which may result in lost revenues and damaged customer relationships.

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

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

with appropriate qualifications. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenues and business could be seriously harmed.

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

Our sales are made on the basis of purchase orders rather than long-term purchase commitments, which our customers may cancel or defer at any time. This process requires us to make multiple demand forecast assumptions, each of which may introduce errors into our estimates. If our customers or we overestimate demand, we may purchase products, which we may not be able to sell. As a result, we would have excess inventory, which would increase our losses. Conversely, if our customers or we underestimate demand or if sufficient manufacturing capacity were 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 had development arrangements with customers and other parties that consume large amounts of engineering resources far in advance of product revenue. Our work under these arrangements is technically challenging and may require deliverables on an accelerated basis. These arrangements place considerable demands on our limited resources, particularly on our most senior engineering talent, and may not result in revenue for twelve to eighteen months, if at all. 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. Because of our relatively limited history in selling our products, no assurance can be given 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 companies that used our products experienced delays in the availability of key components from other suppliers, which, in turn, threatened a delay in demand for the products that we supplied to them.

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

From time to time, shortages of materials that are used in our 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 are not 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 may be 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 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, public health risks, labor strike or political unrest could disrupt our operations.**

Most of our current manufacturers and customers are located in Asian countries, including China, Japan, Korea and Taiwan. Customers located in these countries were responsible for approximately 88% of our revenue for the three months ended June 30, 2003. The Pacific Rim region is susceptible to the risk of earthquakes due to the proximity of major earthquake fault lines in the area. In September 1999, a current manufacturer s facilities were affected by a significant earthquake in Taiwan. As a consequence of this earthquake, this manufacturer suffered power outages and disruption that impaired its production capacity. Earthquakes, fire, flooding and other natural disasters in the Pacific Rim region, or political unrest, labor strikes or work stoppages in countries where our manufacturers and customers are located likely would result in the disruption of our foundry partners assembly capacity. Any disruption resulting from extraordinary events could cause significant delays in shipments of our solutions until we are able to shift our manufacturing or assembling from the affected contractor to another third-party vendor. There can be no assurance that alternative capacity could be obtained on favorable terms, if at all.

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

We may become subject to claims involving patents or other intellectual property rights. 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 could also 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 5 patents and have 36 patent applications pending with the U.S. Patent and Trademark Office for protection of our significant technologies. In addition to filing patents in the United States, we have applied for 12 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. We provide the computer programming code for our software to selected customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software. Competitors in both the United States and foreign countries, many of which have substantially greater resources, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries.

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

We intend to continue to consider investments in or acquisitions of complementary businesses, products or technologies. To date, we have acquired Panstera, Inc. in January 2001, nDSP in January 2002 and Jaldi Semiconductor in September 2002. The acquisitions of Panstera, nDSP and Jaldi contain a very high level of risk primarily because the investments were made based on in-process technological development that may not be completed, or if completed, may not be commercially viable. If this were the case, our financial results would likely be very negatively affected.

These and any future acquisitions and investments could result in:

issuance of stock that dilutes current shareholders percentage of 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 June 30, 2003, goodwill amounted to $82,548, or 35%, of the Company s 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 results of operations.

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

Our ability to successfully market and sell our products in a rapidly evolving market requires effective planning and management processes. We continue to increase the scope of our operations domestically and internationally and have increased our headcount substantially. Through internal growth as well as acquisition, our headcount grew from 176 employees at the end of 2001 to 262 employees on June 30, 2003. Our past growth and our expected future growth place 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 business would be seriously harmed.

**RISKS RELATED TO OUR INDUSTRY**

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

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

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

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

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

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

We compete with a range of specialized and diversified electronic and semiconductor companies that offer display processors. In particular, we compete against Genesis Microchip Inc., I-Chips Co., Ltd., Macronix International Co., Ltd., Mediatek Corp., Media Reality Technologies, Inc., Micronas Semiconductor Holding AG, Mstar Semiconductor, Inc., Oplus Technologies Ltd., , Realtek Semiconductor Corp., Silicon Image, Inc., Silcon Optix Inc., SmartASIC Technology, Inc., STMicroelectronics N.V., Torpo Technology Inc., Trident Microsystems, Inc., Trumpion Microelectrics Inc., and other companies. Potential competitors may include diversified semiconductor manufacturers and the semiconductor divisions or affiliates of some of our customers, including ATI, LG Electronics, Inc., Matsushita Electric Industrial Co., Mitsubishi Corporation, National Semiconductor Corp., NEC Corporation, nVidia, Koninlijke Philips Electronics N.V., Samsung Electronics, Sanyo Electric Co., Ltd.,

Sharp Corporation, Sony Corporation, Texas Instruments, Inc., and Toshiba Corporation. Many of our competitors have

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

**The market for Internet enabled display products may not evolve rapidly enough to support expanded market acceptance of our products and industry standards in this market continue to evolve.**

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

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

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

**OTHER RISKS**

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

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

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

Our executive officers, directors and other principal shareholders, in the aggregate, beneficially owned 10,207 shares or approximately 23% of our outstanding common stock as of June 30, 2003. 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 market price and trading volume of our common stock has and may continue to fluctuate substantially.**

The stock market has experienced large price and volume fluctuations that have affected the market price of many companies and have often been unrelated to the operating performance of these companies. These factors, as well as general economic and political conditions, may adversely affect the market price and trading volumes of our common stock in the future. The market price and trading volume may fluctuate significantly in response 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;

changes in market valuations of other companies;

announcements by us or our competitors of significant technological innovations, design wins, contracts, standards or acquisitions;

the operating and stock price performance of other comparable companies; and

the number of shares of the company that are available for trading by the public and the trading volume of our common stock.

Due to these factors, the price of the Company s common stock may decline and the value of your investment would be reduced.

**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.

**Terrorist acts and acts of war may seriously harm our business.**

Terrorist acts or acts of war, wherever located around the world, may cause damage or disruption to the company, its employees, facilities, partners, suppliers, distributors, and customers, which could significantly impact the company s revenues, expenses and financial condition. The terrorist attacks that took place in the United States on September 11, 2001 were unprecedented events that have created many economic and political uncertainties, some of which may materially harm the company s business and results of operations. The long-term effects on the company of the September 11, 2001 attacks are unknown. The potential for future attacks, hostilities in the Middle East, including Iraq, and other acts of war or hostility, especially in the Korean peninsula, have created economic and political uncertainties, which could adversely affect our business or results of operations that cannot be predicted. In addition, as a company with headquarters and significant operations located in the United States, we could be adversely impacted by any actions against the United States. We are uninsured for loses and interruptions caused by terrorist acts and acts of war.

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

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

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**

An evaluation was carried out under the supervision and with the participation of the Company s management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934. Based on

that evaluation, the CEO and CFO have concluded that the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Subsequent to the date of their evaluation, there were no significant changes in the Company s internal controls or in other factors that could significantly affect the disclosure controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

## PART II - OTHER INFORMATION

**ITEM 4. Submission of Matters to a Vote of Shareholders**

The Company's 2003 Annual Meeting of Shareholders was held on May 23, 2003 to consider and vote upon a proposal to elect directors and a proposal to amend Pixelworks Inc. 1997 Stock Incentive Plan to increase the aggregate number of shares of Pixelworks common stock that may be issued there under 1,500,000 shares to a total of 16,840,116 shares.

The following nominees were elected as Directors by the votes and for the terms indicated below:

| Nominee | For | Withheld | Term Ending |
|---|---|---|---|
| Allen H. Alley | 28,970,236 | 10,038,216 | 2004 |
| Oliver D. Curne | 29,173,650 | 9,834,802 | 2004 |
| Frank Gill | 29,169,165 | 9,839,287 | 2004 |
| Mark A. Stevens | 38,152,327 | 856,125 | 2004 |
| C. Scott Gibson | 29,159,065 | 9,849,387 | 2004 |

The proposal to amend the Pixelworks Inc. 1997 Stock Incentive Plan was approved and received the following votes:

| | Votes |
|---|---|
| For | 36,139,323 |
| Against | 2,801,293 |
| Abstain | 67,836 |
| Broker non-votes | 0 |

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

**(a)** **Exhibits**

10.1

| | |
|---|---|
| | Fourth Amendment to Lease dated June 23, 2003 between Union Bank of California and Pixelworks, Inc.*** |
| 10.2 | Agreement and Plan of Merger dated March 17, 2003, by and among Pixelworks Inc., Display Acquisition Corporation and Genesis Microchip Inc.* |
| 10.3 | Form of Pixelworks Voting Agreement, dated March 17, 2003, by and among Genesis Microchip Inc. and each of the directors of Pixelworks, Inc. ** |
| 10.4 | Form of Genesis Microchip Voting Agreement dated March 17, 2003, by and among Pixelworks, Inc. and each of the directors of Genesis Microchip Inc. ** |
| 10.5 | Form of Pixelworks Change of Control Severance Agreement (as entered into between Pixelworks and each of Allen Alley, Marc Fleischmann, Robert Greenberg, Michael West and Bradley Zenger) ** |
| 10.6 | Change of Control Severance Agreement between Pixelworks and Jeff Bouchard dated as of March 14, 2003** |
| 10.7 | Change of Control Severance Agreement between Pixelworks and Hans Olsen dated as of March 14, 2003** |
| 10.8 | Form of Relocation Agreement between Pixelworks Inc. and Hans Olsen* |
| 31.1 | Certification of Chief Executive Officer |
| 31.2 | Certification of Chief Financial Officer |
| 32.1 | Certification of Chief Executive Officer |
| 32.2 | Certification of Chief Financial Officer |

| | |
|---|---|
| * | Incorporated by reference to the Company s Current Report on Form 8-K filed on March 20, 2003. |
| ** | Incorporated by reference to the Company s Registration Statement on Form S-4 filed on April 18, 2003. |
| *** | Incorporated by reference to the Company s Quarterly Report on Form 10-Q filed on August 14, 2003. |

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

On April 25, 2003, the Company filed a current report on Form 8-K to report under Item 9 that on April 22, 2003 the Company had issued a press release announcing the results for the three-months ended March 31, 2003.

**SIGNATURES**

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

PIXELWORKS, INC.

Date: August 19, 2003

/s/ Jeffrey B. Bouchard

Jeffrey B. Bouchard

*Vice President, Finance and Chief Financial Officer (Principal Financial and Accounting Officer)*