PIXELWORKS, INC
Form 10-Q
August 09, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarterly period ended June 30, 2007.

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

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

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

Number of shares of Common Stock outstanding as of July 31, 2007: 48,935,662.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 67,489	$ 63,095
Short-term marketable securities	42,325	53,985
Accounts receivable, net	9,022	9,315
Inventories, net	16,869	13,809
Prepaid expenses and other current assets	5,556	6,374
Total current assets	141,261	146,578
Long-term marketable securities	15,402	17,504
Property and equipment, net	15,667	21,931
Other assets, net	7,593	9,287
Debt issuance costs, net	2,591	2,922
Acquired intangible assets, net	7,959	9,549
Total assets	$ 190,473	$ 207,771
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 12,984	$ 8,093
Accrued liabilities and current portion of long-term liabilities	17,017	19,319
Current portion of income taxes payable	293	10,997
Total current liabilities	30,294	38,409
Long-term liabilities, net of current portion	4,154	7,414
Income taxes payable, net of current portion	10,241	
Long-term debt	140,000	140,000
Total liabilities	184,689	185,823
Commitments and contingencies		
Shareholders equity:		
Preferred stock		
Common stock	335,330	331,567

Shares exchangeable into common stock	114	450
Accumulated other comprehensive loss	(3,242)	(3,693)
Accumulated deficit	(326,418)	(306,376)
Total shareholders equity	5,784	21,948
Total liabilities and shareholders equity	$ 190,473	$ 207,771

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Revenue, net	$ 26,896	$ 30,910	$ 50,877	$ 67,469
Cost of revenue (1)	15,294	19,322	29,422	64,365
Gross profit	11,602	11,588	21,455	3,104
Operating expenses:				
Research and development (2)	9,675	14,300	21,650	29,993
Selling, general and administrative (3)	7,013	8,489	14,538	18,493
Restructuring	2,635	893	5,403	893
Amortization of acquired intangible assets	90	90	180	423
Impairment loss on goodwill		133,739		133,739
Impairment loss on acquired intangible assets				1,753
Total operating expenses	19,413	157,511	41,771	185,294
Loss from operations	(7,811)	(145,923)	(20,316)	(182,190)
Interest income	1,444	1,396	2,971	2,720
Interest expense	(688)	(676)	(1,345)	(1,374)
Amortization of debt issuance costs	(166)	(165)	(331)	(336)
Gain on repurchase of long-term debt, net				3,009
Interest and other income, net	590	555	1,295	4,019
Loss before income taxes	(7,221)	(145,368)	(19,021)	(178,171)
Provision for income taxes	399	201	1,021	453
Net loss	$ (7,620)	$ (145,569)	$ (20,042)	$ (178,624)
Net loss per share basic and diluted	$ (0.16)	$ (3.02)	$ (0.41)	$ (3.72)
Weighted averages shares outstanding basic and diluted	48,857	48,160	48,819	48,054
(1) Includes:				
Amortization of acquired developed technology	$ 705	$ 705	$ 1,410	$ 2,677

Restructuring	35		136	
Stock-based compensation	28	61	48	119
Impairment loss on acquired developed technology				21,330
Amortization of acquired inventory mark-up				26
(2) Includes stock-based compensation	510	1,026	1,180	2,257
(3) Includes stock-based compensation	916	1,336	1,949	2,847

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Cash flows from operating activities:		
Net loss	$ (20,042)	$ (178,624)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,742	8,759
Stock-based compensation	3,177	5,223
Amortization of acquired intangible assets	1,590	3,100
Write off of certain assets related to restructuring	572	
Amortization of debt issuance costs	331	336
Loss on asset disposals	206	100
Unrealized foreign currency (gain) loss on investments	(201)	34
Accretion on short- and long-term marketable securities	(147)	(111)
Other	26	27
Impairment losses on goodwill and intangible assets		156,822
Gain on repurchase of long-term debt, net		(3,009)
Changes in operating assets and liabilities:		
Accounts receivable, net	293	4,509
Inventories, net	(3,060)	6,365
Prepaid expenses and other current and long-term assets, net	974	1,374
Accounts payable	4,891	(4,740)
Accrued current and long-term liabilities	(1,202)	235
Income taxes payable	(463)	266
Net cash provided by (used in) operating activities	(5,313)	666
Cash flows from investing activities:		
Proceeds from maturities of marketable securities	29,148	30,432
Purchases of marketable securities	(15,556)	(15,013)
Payments on asset financings	(3,609)	(11,458)
Purchases of property and equipment	(1,496)	(3,115)
Proceeds from sales of marketable securities	970	
Purchases of other assets		(150)
Net cash provided by investing activities	9,457	696
Cash flows from financing activities:		
Proceeds from issuances of common stock	250	976
Repurchase of long-term debt		(6,800)

Net cash provided by (used in) financing activities	250	(5,824)
Net change in cash and cash equivalents	4,394	(4,462)
Cash and cash equivalents, beginning of period	63,095	68,604
Cash and cash equivalents, end of period	$ 67,489	$ 64,142

See accompanying notes to condensed consolidated financial statements.

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

NOTE 1: BASIS OF PRESENTATION

Nature of Business

Pixelworks, Inc. (Pixelworks or the Company) is an innovative designer, developer and marketer of semiconductors and software that specializes in video and pixel processing for the advanced display industry. At the core of our technology are unique techniques for intelligently processing signals on a pixel-by-pixel basis that result in images optimized for a variety of digital displays, including multimedia projectors, advanced televisions and liquid crystal display panels. Our flexible design architecture enables our technology to produce high image quality in our customers display products in a range of solutions, including system-on-chip integrated circuits (ICs) and co-processor ICs. We are headquartered in Tualatin, Oregon, with design centers in Shanghai, China and San Jose, California.

Condensed Consolidated Financial Statements

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

The financial information included herein for the three and six month periods ended June 30, 2007 and 2006 is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows of the Company for these interim periods. The financial information as of December 31, 2006 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2006, included in Item 8 of our Annual Report on Form 10-K, filed with the SEC on March 12, 2007, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three and six month periods ended June 30, 2007 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2007.

Use of Estimates

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

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Reclassifications

Certain reclassifications have been made to the 2006 condensed consolidated financial statements to conform with the 2007 presentation.

Adoption of Accounting Pronouncement

On January 1, 2007, we adopted Financial Accounting Standards Board Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 is an interpretation of Statement of Financial Accounting Standard No. (SFAS) 109, *Accounting for Income Taxes* and clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 4 for additional information on income taxes.

NOTE 2: BALANCE SHEET COMPONENTS

Marketable Securities

As of June 30, 2007 and December 31, 2006, all of our short- and long-term marketable securities are classified as available-for-sale.

Unrealized holding losses on short- and long-term available-for-sale securities, net of tax, were $27 and $3,167, respectively, as of June 30, 2007 and $34 and $3,611, respectively, as of December 31, 2006. These unrealized holding losses are recorded in accumulated other comprehensive loss, a component of shareholders equity, in the condensed consolidated balance sheets. We have determined that as of June 30, 2007, gross unrealized losses on our marketable securities were temporary based on our ability to hold the investments until recovery.

Accounts Receivable, Net

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

	June 30, 2007	December 31, 2006
Accounts receivable, gross	$ 9,664	$ 9,515
Less: allowance for doubtful accounts	(642)	(200)
Accounts receivable, net	$ 9,022	$ 9,315

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

	Six Months Ended June 30,	
	2007	2006
Balance at beginning of period	$ 200	$ 212
Provision	483	
Charge offs	(41)	(12)
Balance at end of period	$ 642	$ 200

Inventories, Net

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

Inventories, net consists of the following:

	June 30, 2007	December 31, 2006
Finished goods	$ 13,498	$ 13,260
Work-in-process	9,198	6,499
	22,696	19,759
Less: reserve for slow-moving and obsolete items	(5,827)	(5,950)
Inventory, net	$ 16,869	$ 13,809

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

	Six Months Ended June 30,	
	2007	2006
Balance at beginning of period	$ 5,950	$ 1,396
Provision	2,008	3,447
Usage:		
Utilization	(586)	(218)
Scrap	(1,545)	(1,238)
Total usage	(2,131)	(1,456)
Balance at end of period	$ 5,827	$ 3,387

While we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand at June 30, 2007 based upon our forecast and backlog, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. It is not possible for us to predict if or when this may happen, or how much we may sell. If such sales occur, we do not expect that they will have a material effect on gross profit margin.

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Property and Equipment, Net

Property and equipment, net consists of the following:

	June 30, 2007	December 31, 2006
Gross carrying amount	$ 66,334	$ 65,925
Less: accumulated depreciation and amortization	(50,667)	(43,994)
Property and equipment, net	$ 15,667	$ 21,931

Acquired Intangible Assets, Net

Acquired intangible assets, net consists of the following:

	June 30, 2007	December 31, 2006
Gross carrying amount:		
Developed technology	$ 19,170	$ 19,170
Customer relationships	1,689	1,689
	20,859	20,859
Accumulated amortization:		
Developed technology	(11,554)	(10,144)
Customer relationships	(1,346)	(1,166)
	(12,900)	(11,310)
Acquired intangible assets, net	$ 7,959	$ 9,549

In April 2006, we initiated a restructuring plan to improve our breakeven point by reducing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol Television (IPTV) technology that we acquired as a result of our acquisition of Equator Technologies, Inc. (Equator) in June 2005 with our advanced television technology product developments and we are no longer pursuing these stand-alone digital media streaming markets. As a result, we recorded impairment losses on the developed technology, customer relationships and trademark intangible assets acquired from Equator in the first quarter of 2006. The impairment loss of $23,083 is included in our statement of operations for the six months ended June 30, 2006, of which $21,330 is related to developed technology and is included in cost of revenue.

Estimated future amortization of acquired intangible assets is as follows:

Six Months Ending December 31:	
2007	$ 1,589
Year Ending December 31:	
2008	2,984
2009	2,336
2010	1,050
	$ 7,959

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Goodwill

We recorded goodwill in connection with our acquisitions of Equator in June 2005, nDSP in January 2002 and Panstera in January 2001. As the market value of the Company s common stock fell below its book value during the second quarter of 2006, we performed an impairment analysis on our goodwill. The analysis allocated the fair value of the Company s equity to the fair value of the Company s assets and liabilities. In the allocation, goodwill was determined to have no implied fair value and as a result, the entire balance was written off and we recorded a $133,739 impairment loss on goodwill in the second quarter of 2006.

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	June 30, 2007	December 31, 2006
Current portion of accrued liabilities for asset financings	$ 6,299	$ 7,733
Accrued payroll and related liabilities	5,649	6,130
Reserve for warranty returns	842	662
Current portion of accrued remaining lease payments	515	762
Accrued commissions and royalties	496	693
Accrued interest payable	426	399
Reserve for sales returns and allowances	175	479
Other	2,615	2,461
	$ 17,017	$ 19,319

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Reserve for warranty returns:		
Balance at beginning of period	$ 662	$ 577
Provision	682	871
Product returns	(502)	(624)
Balance at end of period	$ 842	$ 824
Reserve for sales returns and allowances:		
Balance at beginning of period	$ 479	$ 237
Provision	18	265
Product returns	(322)	(259)
Balance at end of period	$ 175	$ 243

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Long-Term Debt

As of June 30, 2007, we have $140,000 of convertible subordinated debentures (the debentures) outstanding. The debentures are due in 2024 and bear interest at a rate of 1.75% per annum, payable on May 15th and November 15th of each year.

The debentures are convertible, under certain circumstances, into our common stock at a conversion rate of 41.0627 shares of common stock per $1 principal amount of debentures for a total of 5,748,778 shares. This is equivalent to a conversion price of approximately $24.35 per share. The debentures are convertible if (a) our stock trades above 130% of the conversion price for 20 out of 30 consecutive trading days during any calendar quarter, (b) the debentures trade at an amount less than or equal to 98% of the if-converted value of the notes for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other specified corporate transactions.

We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of their debentures on May 15, 2011, May 15, 2014 and May 15, 2019 at a price equal to 100% of the principal amount plus accrued and unpaid interest.

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

In February 2006, we repurchased in the open market, and retired, $10,000 of our outstanding debentures for $6,800. We recognized a gain on the repurchase of $3,200 which is included in other income in our consolidated statement of operations for the six months ended June 30, 2006, net of a write-off of $191 of debt issuance costs.

NOTE 3: RESTRUCTURING PLANS

In April 2006, we initiated a restructuring plan to improve our breakeven point by reducing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the IPTV technology that we acquired from Equator with our advanced television technology product development and we are no longer pursuing these stand-alone digital media streaming markets.

In November 2006, we initiated an additional restructuring plan to further reduce operating expenses. This additional plan includes further consolidation of our operations in order to achieve reduced compensation and rent expenses, while at the same time making critical infrastructure investments in people, process and information systems to improve our operating efficiency.

The following is a summary of restructuring expense incurred during the six months ended June 30, 2007 and the cumulative amount incurred through June 30, 2007:

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	Six Months Ended June 30, 2007	Cumulative Amount Incurred To June 30, 2007
Cost of revenue restructuring:		
Termination and retention benefits	$ 136	$ 183
Licensed technology and tooling write-offs		2,072
	136	2,255
Operating expenses restructuring:		
Termination and retention benefits	3,432	6,166
Licensed technology, software and other asset write offs	828	9,318
Consolidation of leased space	933	3,025
Other	210	210
	5,403	18,719
Total restructuring expense	$ 5,539	$ 20,974

The following is a rollforward of the accrued liabilities related to the restructurings for the six months ended June 30, 2007:

	Balance as of December 31, 2006	Expensed / (Adjustments)	Payments	Balance as of June 30, 2007
Termination and retention benefits	$ 1,193	$ 3,568	$ (2,689)	$ 2,072
Consolidation of leased space	1,524	933	(1,097)	1,360
Other		210	(155)	55
Total	$ 2,717	$ 4,711	$ (3,941)	$ 3,487

As we continue implementing the restructuring plan announced in November 2006, we expect to incur additional restructuring charges primarily over the remainder of 2007, consisting mostly of costs related to termination and retention benefits and consolidation of leased space.

NOTE 4: INCOME TAXES

Income tax expense for the periods ended June 30, 2007 and 2006 was recorded for continuing operations in profitable, cost-plus foreign jurisdictions, and contingent amounts related to potential tax exposures in foreign jurisdictions. As of June 30, 2007, we have recorded a valuation allowance against substantially all of our net deferred tax assets as we cannot conclude that it is more likely than not that we will be able to realize the benefit of these assets.

On January 1, 2007, we adopted FIN 48. As a result of the adoption of FIN 48, we conducted a comprehensive review of our uncertain tax positions. We did not record any adjustment to retained earnings as a result of this analysis. As of January 1, 2007, the amount of our uncertain tax positions was

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a liability of $10,490. As of June 30, 2007, the amount of our uncertain tax positions is a liability of $10,241, all of which is classified as long-term in accordance with FIN 48. As of December 31, 2006, prior to the adoption of FIN 48, this liability is classified as current and included in current portion of income taxes payable in our condensed consolidated balance sheet.

Following is a rollforward of our liability for uncertain tax positions, exclusive of interest and penalties:

	Six Months Ended June 30, 2007	
Balance at beginning of period	$	8,743
Accrual for positions taken in a prior year		379
Settlements		(738)
Balance at end of period	$	8,384

Following is a rollforward of interest and penalties included in the liability for uncertain tax positions:

	Six Months Ended June 30, 2007	
Balance at beginning of period	$	1,747
Accrual for positions taken in a prior year		204
Settlements		(94)
Balance at end of period	$	1,857

We recognize interest and penalties related to uncertain tax positions in income tax expense in our statement of operations.

As of January 1, 2007, we were subject to income tax examination for the years 2003 through 2005 in a single foreign jurisdiction. As of June 30, 2007, this examination is closed.

If the uncertain tax positions we have accrued for are sustained by the taxing authorities in our favor, the reduction of the liability will reduce our effective tax rate. We anticipate that we will continue to accrue interest, penalties and contingent tax amounts related to these uncertain tax positions during 2007. We do not anticipate any further reductions to the amounts accrued during 2007.

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NOTE 5: COMPREHENSIVE LOSS

Total comprehensive loss was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net loss	$ (7,620)	$ (145,569)	$ (20,042)	$ (178,624)
Unrealized gain (loss) on available-for-sale investments, net of tax	(80)	(490)	451	299
Total comprehensive loss	$ (7,700)	$ (146,059)	$ (19,591)	$ (178,325)

NOTE 6: EARNINGS PER SHARE

We calculate earnings per share in accordance with SFAS 128, *Earnings per Share*. Basic earnings per share amounts are computed based on the weighted average number of common shares outstanding, and include exchangeable shares. These exchangeable shares, which were issued on September 6, 2002 by Jaldi, our Canadian subsidiary, to its shareholders in connection with the Jaldi asset acquisition, have characteristics essentially equivalent to Pixelworks common stock.

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

The following weighted average shares were excluded from the calculation of diluted weighted average shares outstanding as their effect would have been anti-dilutive because of our net loss position for the periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Stock options	6,059,389	8,908,416	6,348,487	9,027,131
Conversion of debentures	5,748,778	5,748,778	5,748,778	5,847,465
Unvested stock awards	97,253		48,895	

Net loss and weighted average shares used in the calculation of diluted net loss per share were the same as net loss and weighted average shares used in the calculation of basic net loss per share for the three and six month periods ended June 30, 2007 and 2006.

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NOTE 7: SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information is as follows:

	Six Months Ended June 30,	
	2007	2006
Cash paid during the period for:		
Interest	$1,318	$1,345
Income taxes	1,457	58
Non-cash investing and financing activities:		
Acquisitions of property and equipment and other assets under extended payment terms	$	$5,451
Tenant improvement allowances received		959

NOTE 8: SEGMENT INFORMATION

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

Geographic Information

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Japan	$ 15,201	$ 13,838	$ 28,194	$ 26,895
Taiwan	2,798	4,074	5,823	9,135
Korea	1,852	3,363	4,278	7,954
Europe	1,419	2,026	3,067	5,136
China	1,421	2,951	2,823	7,677
U.S.	1,461	1,179	2,522	3,619
Other	2,744	3,479	4,170	7,053
	$ 26,896	$ 30,910	$ 50,877	$ 67,469

Significant Customers

Sales to distributors represented 63% and 50% of total revenue for the three months ended June 30, 2007 and 2006, respectively, and 59% and 46% for the six months ended June 30, 2007 and 2006, respectively. One distributor accounted for more than 10% of total revenue for the three and six month periods ended June 30, 2007 and 2006. This distributor represented 36% and 25% of revenue for the three months

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ended June 30, 2007 and 2006, respectively, and 34% and 23% for the six months ended June 30, 2007 and 2006, respectively.

End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and manufacturers representatives. Revenue attributable to our top five end customers represented 46% and 43% of revenue for the three months ended June 30, 2007 and 2006, respectively, and 47% and 38% for the six months ended June 30, 2007 and 2006, respectively. One end customer accounted for more than 10% of total revenue for the three and six month periods June 30, 2007 and 2006. This end customer represented 17% of revenue for the three months ended June 30, 2007 and 2006, and 19% and 15% for the six months ended June 30, 2007 and 2006, respectively.

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

	June 30, 2007	**December 31, 2006**
Account A	28%	23%
Account B	16%	10%
Account C	7%	13%
Account D	6%	10%

NOTE 9: RISKS AND UNCERTAINTIES

Concentration of Suppliers

We do not own or operate a semiconductor fabrication facility and do not have the resources to manufacture our products internally. We rely on four third-party foundries to produce all of our products and we do not have any long-term agreements with any of these suppliers. In light of these dependencies, it is reasonably possible that failure to perform by any one of these suppliers could have a material adverse effect on our results of operations.

Risk of Technological Change

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

Concentrations of Credit Risk

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

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NOTE 10: COMMITMENTS AND CONTINGENCIES

Indemnifications

Certain of our agreements include limited indemnification provisions for claims from third-parties relating to intellectual property. Such indemnification provisions are accounted for in accordance with FIN 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. The amount of the indemnification is generally limited to the amount paid by the customer. As of June 30, 2007, we have not incurred any material liabilities arising from these indemnification obligations, however in the future, such obligations could immediately impact our results of operations.

Legal Proceedings

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

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

Forward-looking Statements

This Management s Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Report contain forward-looking statements within the meaning of the Securities Litigation Reform Act of 1995 that are based on current expectations, estimates, beliefs, assumptions and projections about our business. Words such as expects, anticipates, intends, targets, plans, believes, seeks, estimates, may, will, should and words, and similar expressions, are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors. Such factors include the risks and uncertainties in Part II, Item 1A, under Risk Factors , including, without limitation to:

- failure to reduce costs or improve operating efficiencies, including our success in achieving operating efficiencies from our restructuring efforts;
- our ability to execute our new strategy;
- changes in growth in the markets in which we participate or seek to participate;
- changes in customer ordering patterns or lead times;
- failure to design, develop and manufacture new products;
- lack of acceptance of new products;
- lack of success in technological advancements;
- unexpected changes in the demand for our products and services;
- the success of our products in expanded markets;
- competitive factors, such as increased competition, rival chip architectures, introduction of, or traction by, competing designs or pricing pressures;
- new product yield rates;
- non-acceptance of the combined technologies by leading manufacturers;
- insufficient, excess or obsolete inventory, variations in inventory valuation and the inability to successfully manage inventory pricing pressures;
- our ability to attract, hire and retain key and qualified employees;
- adverse economic conditions in the U.S. and internationally;
- changes to and compliance with international laws and regulations;
- currency fluctuations; and
- changes in recoverability of long-lived assets and intangible assets.

These forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q. If we do update or modify one or more forward-looking statements, you should not conclude that we will make additional updates or modifications with respect thereto or with respect to other forward-looking statements.

(Dollars in thousands, except per share data)

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Overview

We are an innovative designer, developer and marketer of semiconductors and software that specializes in video and pixel processing for the advanced display industry. At the core of our technology are unique techniques for intelligently processing signals on a pixel-by-pixel basis that result in images optimized for a variety of digital displays, including multimedia projectors, advanced televisions and liquid crystal display panels. Our flexible design architecture enables our technology to produce high image quality in our customers display products in a range of solutions, including system-on-chip integrated circuits (ICs) and co-processor ICs.

We sell our products worldwide through a direct sales force and indirectly through distributors and manufacturers representatives. We sell to distributors in Japan, Taiwan, China and Europe, and our manufacturers representatives support some of our European and Korean sales. Sales to distributors represented 63% and 50% of total revenue for the three months ended June 30, 2007 and 2006, respectively, and 59% and 46% for the six months ended June 30, 2007 and 2006, respectively. Our distributors typically provide engineering support to our end customers and often have valuable and established relationships with our end customers. In certain countries it is customary to sell to distributors. While distributor payment to us is not dependent upon the distributor s ability to resell the product or to collect from the end customer, the distributors may provide longer payment terms to end customers than those we would offer.

Historically, significant portions of our revenue have been generated by sales to a relatively small number of end customers and distributors. End customers include customers who purchase directly from us, as well as customers who purchase our products indirectly through distributors and manufacturers representatives. Revenue attributable to our top five end customers represented 46% and 43% of total revenue for the three months ended June 30, 2007 and 2006, respectively, and 47% and 38% for the six months ended June 30, 2007 and 2006, respectively.

Significant portions of our products are sold overseas. Sales outside the U.S. accounted for approximately 95% and 96% of total revenue for the three months ended June 30, 2007 and 2006, respectively, and 95% for the six months ended June 30, 2007 and 2006. Our integrators, branded manufacturers and branded suppliers incorporate our products into systems that are sold worldwide. All revenue to date has been denominated in U.S. dollars.

In April 2006, we initiated a restructuring plan to improve our breakeven point by reducing manufacturing overhead and operating expenses and focusing on our core business. The plan included integrating the Internet Protocol television (IPTV) technology that we acquired from Equator Technologies, Inc. (Equator) with our advanced television technology developments and we are no longer pursuing these stand-alone digital media streaming markets. This focus and integration has resulted in lower compensation costs and has allowed us to consolidate and reduce office space.

In November 2006, we initiated an additional restructuring plan to further reduce operating expenses. This plan includes further consolidation of our North American operations in order to achieve reduced compensation and rent expenses, while at the same time making critical infrastructure investments in people, process and information systems to improve our operating efficiency.

During the six months ended June 30, 2007, we incurred expenses of $5,539 related to the restructuring plan announced in November 2006, which consists of costs associated with termination and retention benefits of $3,568 and the consolidation of leased space of $933, the write-off of certain assets of $828 and other expenses of $210. Through June 30, 2007, the cumulative amount incurred related to the restructuring plans announced in 2006 is $20,974, of which $2,255 is included in cost of revenue. As we continue implementing the restructuring plan announced in November 2006, we expect to incur additional restructuring charges primarily over the remainder of 2007.

During the six months ended June 30, 2006, we performed impairment analyses on goodwill and the intangible assets acquired from Equator. In the first quarter of 2006, we recorded an impairment loss of $23,083 on the acquired intangible assets. This impairment loss represented the excess of the carrying amount over the estimated fair value of the intangible assets. In the second quarter of 2006, we recorded an impairment loss of $133,739 on the goodwill. This impairment loss represented the excess carrying amount of the goodwill over the implied fair value of the goodwill.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition. We recognize revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition*. Accordingly, revenue is recognized when an authorized purchase order has been received, title and risk of loss have transferred, the sales price is fixed or determinable, and collectibility of the receivable is reasonably assured. This generally occurs upon shipment of the underlying merchandise.

Sales Returns and Allowances. Our customers do not have a stated right to return product except for replacement of defective products under our warranty program discussed below. However, we have accepted customer returns on a case-by-case basis as customer accommodations in the past. As a result, we provide for these returns in our reserve for sales returns and allowances. At the end of each reporting period, we estimate the reserve based on historical experience and knowledge of any applicable events or transactions.

Certain of our distributors have stock rotation provisions in their distributor agreements, which allow them to return 5-10% of the products purchased in the prior six months in exchange for products of equal value. We analyze historical stock rotations at the end of each reporting period. To date, returns under the stock rotation provisions have been nominal.

Certain distributors also have price protection provisions in their distributor agreements with us. Under the price protection provisions, we grant distributors credit if they purchased product for a specific customer and we subsequently lower the price to the customer such that the distributor can no longer earn its negotiated margin on in-stock inventory. At the end of each reporting period, we estimate a reserve for price protection credits based on historical experience and knowledge of any applicable events or transactions. The reserve for price protection is included in our reserve for sales returns and allowances.

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

At the end of each reporting period, we estimate a reserve for warranty returns based on historical experience and knowledge of any applicable events or transactions. While we engage in extensive product quality programs and processes, which include actively monitoring and evaluating the quality of our suppliers, should actual product failure rates or product replacement costs differ from our estimates, revisions to the estimated warranty liability may be required.

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

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

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

Stock-Based Compensation. In accordance with SFAS 123R, *Share-Based Payment*, we estimate the fair value of share-based payments using the Black-Scholes option pricing model, which requires certain estimates, including an expected forfeiture rate and expected term of options granted. We also make decisions regarding the method of calculating expected volatilities and the risk-free interest rates used in the option-pricing model. The resulting calculated fair value of the share-based payment is recognized as compensation expense over the requisite service period, generally the vesting period. When there are any changes to the assumptions used in the option-pricing model, including fluctuations in market price of our common stock, there will be variations in calculated fair value of the share-based payments, causing variation in the compensation cost recognized.

Income Taxes. Deferred income taxes are provided for temporary differences between the amount of assets and liabilities for financial and tax reporting purposes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Tax contingency reserves are recorded to address potential exposures involving tax positions we have taken that could be challenged by taxing authorities. These potential exposures result from the varying applications of statutes, rules, regulations and interpretations. Our tax contingency reserves contain assumptions based

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on past experiences and judgments about potential actions by taxing jurisdictions. The ultimate resolution of these matters may be greater or less than the amount that we have accrued.

Results of Operations

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2007		2006		2007		2006	
	Dollars	% of Revenue	Dollars	% of Revenue	Dollars	% of Revenue	Dollars	% of Revenue
Revenue, net	$ 26,896	100.0%	$ 30,910	100.0%	$ 50,877	100.0%	$ 67,469	100.0%
Cost of revenue	15,294	56.9	19,322	62.5	29,422	57.8	64,365	95.4
Gross profit	11,602	43.1	11,588	37.5	21,455	42.2	3,104	4.6
Operating expenses:								
Research and development	9,675	36.0	14,300	46.3	21,650	42.6	29,993	44.5
Selling, general and administrative	7,013	26.1	8,489	27.5	14,538	28.6	18,493	27.4
Restructuring	2,635	9.8	893	2.9	5,403	10.6	893	1.3
Amortization of acquired intangible assets	90	0.3	90	0.3	180	0.4	423	0.6
Impairment loss on goodwill			133,739	432.7			133,739	198.2
Impairment loss on acquired intangible assets							1,753	2.6
Total operating expenses	19,413	72.2	157,511	509.6	41,771	82.1	185,294	274.6
Loss from operations	(7,811)	(29.0)	(145,923)	(472.1)	(20,316)	(39.9)	(182,190)	(270.0)
Interest income	1,444	5.4	1,396	4.5	2,971	5.8	2,720	4.0
Interest expense	(688)	(2.6)	(676)	(2.2)	(1,345)	(2.6)	(1,374)	(2.0)
Amortization of debt issuance costs	(166)	(0.6)	(165)	(0.5)	(331)	(0.7)	(336)	(0.5)
Gain on repurchase of long-term debt, net							3,009	4.5
Interest and other income, net	590	2.2	555	1.8	1,295	2.5	4,019	6.0

Loss before income taxes	(7,221)	(26.8)	(145,368)	(470.3)	(19,021)	(37.4)	(178,171)	(264.1)
Provision for income taxes	399	1.5	201	0.7	1,021	2.0	453	0.7
Net loss	$ (7,620)	(28.3)%	$ (145,569)	(470.9)%	$ (20,042)	(39.4)%	$ (178,624)	(264.7)%

Percentages may not add due to rounding.

Revenue, Net

Revenue decreased $4,014, or 13%, in the second quarter of 2007 compared to the second quarter of 2006. This decrease resulted from a decrease in units sold of 26%, partially offset by an increase in average selling prices (ASP) of 17%. Revenue decreased $16,592, or 25%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. This decrease resulted from a decrease in units sold of 31%, partially offset by an increase in ASP of 9%.

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Revenue by market was as follows:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2007		2006		2007		2006	
	Dollars	% of Revenue	Dollars	% of Revenue	Dollars	% of Revenue	Dollars	% of Revenue
Multimedia projector	$ 13,536	50%	$ 14,563	47%	$ 26,221	52%	$ 28,459	42%
Advanced television	4,465	17%	8,326	27%	10,222	20%	22,098	33%
Digital streaming media devices	4,643	17%	4,803	16%	8,583	17%	10,069	15%
LCD monitor, panel and other	4,252	16%	3,218	10%	5,851	11%	6,843	10%
	$ 26,896	100%	$ 30,910	100%	$ 50,877	100%	$ 67,469	100%

Multimedia Projector

Multimedia projector revenue decreased 7% and 8% in the three and six month periods ended June 30, 2007, respectively, relative to the comparable periods of 2006. These decreases were driven by a decrease in units sold of 13% in the second quarter of 2007 compared to the second quarter of 2006, partially offset by an increase in ASP of 6%, and a decrease in units sold of 12% in the six months ended June 30, 2007 compared to the six months ended June 30, 2006, partially offset by an increase in ASP of 5%. The decreases in units sold are primarily due to product integration, which resulted in sales of our one chip solutions rather than our two chip solutions. The increases in ASP are attributable to a shift in the mix of products sold away from end-of-life legacy products with lower ASP to our next generation products which have higher ASP.

We expect revenue from the multimedia projector market for the third quarter of 2007 to be up approximately 12% to 16% from the second quarter of 2007.

Advanced Television

Revenue in the advanced television market includes products sold into the flat panel television sector, which is comprised of liquid crystal display (LCD) and plasma televisions, and products sold into digital cathode ray tube (CRT) and digital rear projection televisions. Advanced television revenue decreased 46% and 54% in the three and six month periods ended June 30, 2007, respectively, relative to the comparable periods of 2006.

The decreases in advanced television revenue were driven by a decrease in units sold of 52% in the second quarter of 2007 compared to the second quarter of 2006, partially offset by an increase in ASP of 13%, and decreases in units sold of 52% and ASP of 3% in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. The decreases in units sold are primarily due to a lack of new design wins, which resulted from our decision to shift focus away from this market.

While we expect revenue from the advanced television market for the third quarter of 2007 to be relatively unchanged from revenue in the second quarter of 2007, over the long term we anticipate continuing decreases in revenue from the advanced television market.

Digital Streaming Media Devices

Digital streaming media devices revenue decreased 3% and 15% in the three and six month periods ended June 30, 2007, respectively, relative to the comparable periods of 2006. These decreases were driven by decreases in units sold of 2% and ASP of 1% in the second quarter of 2007 compared to the second quarter

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of 2006, and decreases in units sold of 5% and ASP of 10% in the six months ended June 30, 2007 compared to the six months ended June 30, 2006.

In April 2006, we initiated a restructuring plan whereby we integrated the IPTV technology that we acquired from Equator with our advanced television technology developments. While we are continuing to provide customers with existing products, we are no longer pursuing stand-alone digital media streaming markets that are not core to our business.

While we expect third quarter 2007 revenue from this market to be up 8% to 16% from second quarter 2007 revenue due to increased demand for our end customers existing products, we expect to see revenue from this market decreasing over time as customers migrate to next generation designs from other suppliers.

LCD Monitor, Panel and Other

LCD monitor, panel and other revenue increased 32% in the three months ended June 30, 2007 relative to the comparable period of 2006, and decreased 14% in the six months ended June 30, 2007 relative to the comparable period of 2006. The increase in the second quarter of 2007 compared to the second quarter of 2006 is due to an increase in units sold of 11% and an increase in ASP of 19%. Units sold decreased 3% in the six months ended June 30, 2007 compared to the six months ended June 30, 2006, and ASP decreased 12% in the six months ended June 30, 2007 compared to the six months ended June 20, 2006. The increase in units sold and ASP in the second quarter of 2007 compared to the second quarter of 2006 resulted primarily from last time buys of an end-of-life product. The decrease in units sold in the six months ended June 30, 2007 compared to the six months ended June 30, 2006 is primarily due to our decision to focus on higher end products and the developing market for LCD panels, rather than general industry trends.

We expect LCD monitor, panel and other revenue for the third quarter of 2007 to be down approximately 35% to 50% from the second quarter of 2007.

Cost of Revenue and Gross Profit

Cost of revenue includes purchased materials, assembly, test, labor, warranty expense, royalties, provisions for slow-moving and obsolete inventory, restructuring charges and non-cash expenses for stock-based compensation and amortization of acquired intangible assets.

Gross profit margin in the second quarter of 2007 was 43.1%, compared to gross profit margin of 37.5% in the second quarter of 2006 and 42.2% in the six months ended June 30, 2007 compared to 4.6% in the six months ended June 30, 2006.

The increase in gross profit margin in the second quarter of 2007 compared to the second quarter of 2006 resulted primarily from a decrease in the provision for slow-moving and obsolete inventory and decreased charges for custom production materials that were never utilized. During 2006, we experienced an increase in the provision for slow-moving and obsolete inventory primarily due to regulations imposed by the European Union s Restriction of Hazardous Substance Directive, which prevents us from selling parts containing specific hazardous substances such as lead to our European customers.

The increase in gross profit margin in the six months ended June 30, 2007 compared to the six months ended June 30, 2006 resulted primarily from the recognition of an impairment loss on acquired developed technology of $21,330 in 2006. Additionally, a decrease in the provision for slow-moving and obsolete inventory, decreased charges for custom production materials never utilized, decreased warranty expense and decreased amortization of acquired developed technology contributed to the increase in gross profit margin in the six months ended June 30, 2007 compared to the six months ended June 30, 2006.

Estimated amortization of acquired developed technology is $1,410 for the six months ending December 31, 2007, and $2,820, $2,336 and $1,050 for the years ending December 31, 2008, 2009 and 2010, respectively.

We expect our gross profit margin to be between 41.5% and 43.5% in the third quarter of 2007.

Research and Development

Research and development expense includes compensation and related costs for personnel, depreciation and amortization, fees for outside services, expensed equipment, and information technology and facilities allocations.

Research and development expense decreased $4,625, or 32%, in the second quarter of 2007 compared to the second quarter of 2006 primarily due to the following:

- Compensation expense decreased $2,214 due to fewer research and development personnel. As of June 30, 2007, we had 186 employees in research and development compared to 244 as of June 30, 2006. This decrease is primarily due to the restructuring efforts that we initiated in April and November 2006.
- Outside services and non-recurring engineering and development expenses decreased $1,440 as a result of our restructuring efforts.
- Stock-based compensation expense decreased $516 as a result of the decrease in the number of employees.
- Facilities and information technology allocations decreased $418 due to fewer employees and decreased rent expense, both of which resulted from our restructuring efforts.

Research and development expense decreased $8,343, or 28%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006 primarily due to the following:

- Compensation expense decreased $3,865 due to fewer research and development personnel.
- Outside services and non-recurring engineering and development expenses decreased $2,207 as a result of our restructuring efforts.
- Stock-based compensation expense decreased $1,077 as a result of the decrease in the number of employees.
- Facilities and information technology allocations decreased $583 due to fewer employees and decreased rent expense, both of which resulted from our restructuring efforts.

As we continue to implement our November 2006 restructuring plan throughout 2007, we expect to make investments in research and development in support of our new products, while at the same time identifying operating efficiencies and reducing expenditures where appropriate.

Selling, General and Administrative

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

Selling, general and administrative expense decreased $1,476, or 17%, in the second quarter of 2007 compared to the second quarter of 2006 primarily due to the following:

- Compensation expense decreased $647 due to fewer selling, general and administrative personnel. As of June 30, 2007, we had 130 employees in sales and marketing and administrative functions compared to 153 as of June 30, 2006. This decrease is primarily due to the restructuring efforts that we initiated in April and November 2006.
- Stock-based compensation expense decreased $420 as a result of the decrease in the number of employees.
- Sales commissions decreased $133 as a result of the overall decrease in revenue.
- Depreciation and amortization expense decreased $114.

Selling, general and administrative expense decreased $3,955, or 21%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006 primarily due to the following:

- Compensation expense decreased $1,441 due to fewer selling, general and administrative personnel.
- Stock-based compensation expense decreased $898 as a result of the decrease in the number of employees.
- Sales commissions decreased $393 as a result of the overall decrease in revenue.
- Trade show and travel and entertainment expenses decreased $253.
- Depreciation and amortization expense decreased $220.

As we continue to implement our November 2006 restructuring plan throughout 2007, we expect to make investments in selling, general and administrative infrastructure to support the scalability of our business, while at the same time identifying operating efficiencies and reducing expenditures where appropriate.

Restructuring

As a result of the restructuring plans announced in 2006, we recognized restructuring expenses of $2,635 and $893 in the second quarter of 2007 and 2006, respectively, and $5,403 and $893 in the six month periods ended June 30, 2007 and 2006, respectively. The cumulative restructuring charges incurred through June 30, 2007 related to these restructuring plans consist of termination and retention benefits of $6,349, the write-off of certain assets of $11,390, costs related to the consolidation of leased space of $3,025 and other of $210, of which, $2,255 is classified in cost of sales. As of June 30, 2007, we have accrued restructuring expenses of approximately $3,487 in our condensed consolidated balance sheet, consisting of termination and retention benefits payable of $2,072, lease consolidation costs of $1,360 and other of $55.

As we continue implementing the November 2006 restructuring plan, we expect to incur additional restructuring charges over the remainder of 2007, consisting primarily of costs related to termination and retention benefits and the consolidation of leased space.

Amortization of Acquired Intangible Assets

We recorded a customer relationship intangible asset and a trademark intangible asset in connection with the acquisition of Equator in June 2005. Amortization of acquired intangible assets consists of the amortization of the customer relationship asset in 2007, and amortization of the customer relationship and trademark assets in 2006. Estimated amortization of the customer relationship asset is $179 for the six months ending December 31, 2007 and $164 for the year ending December 31, 2008.

Impairment Loss on Goodwill

We recorded goodwill in connection with our acquisitions of Equator in June 2005, nDSP in January 2002, and Panstera in January 2001. In the second quarter of 2006, we recorded an impairment loss on goodwill of $133,739, which represented the excess carrying amount over the implied fair value of goodwill.

Impairment Loss on Acquired Intangible Assets

In the first quarter of 2006, we recorded an impairment loss on the customer relationships and trademark intangible assets of $1,753, which represented the excess of the carrying amount over the estimated fair value of the assets. The customer relationships intangible asset is being amortized over its remaining useful life, while the trademark asset was determined to have no remaining value and was written off entirely.

Interest and Other Income, Net

Interest and other income, net includes interest income earned on cash equivalents and short- and long-term marketable securities, interest expense related to our 1.75% long-term debt, the amortization of debt issuance costs, and a gain on the repurchase of long-term debt in 2006.

Interest and other income, net increased $35, or 6%, in the second quarter of 2007 compared to the second quarter of 2006. This increase is primarily due to an increase in interest income of $48, or 3%, which resulted from an increase in interest rates during the second quarter of 2007 compared to the second quarter of 2006.

Interest and other income, net decreased $2,724, or 68%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. This decrease is primarily due to the recognition of a gain of $3,009 in the first quarter of 2006 related to the repurchase of $10,000 of our 1.75% outstanding debentures, offset by an increase in interest income of $251, or 9%, which resulted from an increase in interest rates.

Provision for Income Taxes

The provision for income taxes was $399 and $1,021 for the three and six month periods ended June 30, 2007, respectively, and $201 and $453 for the three and six month periods ended June 30, 2006, respectively. The effective tax rate differs from the federal statutory rate primarily due to the generation of net operating loss and federal, state and foreign tax credit carryforwards, offset by the establishment of a valuation allowance against such carryforwards, as well as current taxes payable in profitable cost plus foreign jurisdictions and contingent amounts recorded for potential exposures in foreign jurisdictions.

Liquidity and Capital Resources

Cash and Cash Equivalents and Short- and Long-term Marketable Securities

As of June 30, 2007, we had cash and cash equivalents of $67,489, short- and long-term marketable securities of $57,727 and working capital of $110,967. Cash used in operating activities was $5,313 for the six months ended June 30, 2007 compared to cash provided by operating activities of $666 for the six months ended June 30, 2006. Cash used in operating activities during the six months ended June 30, 2007 resulted primarily from the net loss incurred and an increase in inventory during the period, partially offset by an increase in accounts payable. Cash provided by operating activities during the six months ended June 30, 2006 resulted primarily from decreases in accounts receivable and inventory balances, offset by the net loss incurred and a decrease in accounts payable.

Cash provided by investing activities was $9,457 for the six months ended June 30, 2007 compared to $696 for the six months ended June 30, 2006. Cash provided by investing activities for the six months ended June 30, 2007 consisted of proceeds from maturities and sales of marketable securities, partially offset by purchases of marketable securities, payments on asset financings, and purchases of property and equipment. Cash provided by investing activities for the six months ended June 30, 2006 consisted of proceeds from maturities of marketable securities partially offset by purchases of marketable securities, payments on asset financings, and purchases of property and equipment.

Cash provided by financing activities was $250 for the six months ended June 30, 2007 compared to cash used in financing activities of $5,824 for the six months ended June 30, 2006. Cash provided by financing activities for the six months ended June 30, 2007 consisted of proceeds from issuances of common stock under the stock option and employee stock purchase plans. Cash used in financing activities for the six months ended June 30, 2006 included the repurchase of long-term debt, partially offset by proceeds from issuances of common stock under the stock option and employee stock purchase plans.

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

Accounts Receivable, Net

Accounts receivable, net decreased to $9,022 at June 30, 2007 from $9,315 at December 31, 2006. This decrease is primarily attributable to a decrease in revenue in the second quarter of 2007 compared to the fourth quarter of 2006. Average days sales outstanding increased to 30 days at June 30, 2007 from 28 days at December 31, 2006.

Inventories, Net

Inventories, net increased to $16,869 as of June 30, 2007 from $13,809 as of December 31, 2006. As a result of the increased inventory balance, inventory turnover on an annualized basis decreased to 3.8

times at June 30, 2007 from 4.9 times at December 31, 2006. As of June 30, 2007, this represents approximately 14 weeks of inventory on hand.

Off-Balance Sheet Arrangements

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

Contractual Obligations

Our contractual obligations for 2007 and beyond are included in our Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 12, 2007. Obligations for 2007 and beyond have not changed materially as of June 30, 2007, except as presented below.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. As of June 30, 2007, we have accrued uncertain tax positions of $10,241, and it is unknown when such uncertain tax positions will be resolved.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company beginning January 1, 2008. The provisions of SFAS 157 will be applied prospectively and we are currently in the process of assessing the impact that the adoption of SFAS 157 will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for the Company beginning January 1, 2008, with the provisions of SFAS 159 being applied prospectively. We are currently in the process of assessing the impact that the adoption of SFAS 159 will have on our consolidated financial statements.

In June 2007, the Emerging Issues Task Force reached a consensus on Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3), which requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as goods are delivered or services are performed. On a continuous basis, entities should evaluate whether they expect the goods or services to be rendered, and if not, the capitalized advance payment should be charged to expense in the period such determination is made. EITF 07-3 is effective for fiscal years beginning after December 15, 2007 and earlier application is not permitted. We are currently in the process of assessing the impact the adoption of EITF 07-3 will have on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

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As of June 30, 2007, we had convertible subordinated debentures of $140,000 outstanding with a fixed interest rate of 1.75%. Interest rate changes affect the fair value of the debentures, but do not affect our earnings or cash flow.

All of our sales are denominated in U.S. dollars and as a result, we have relatively little exposure to foreign currency exchange risk with respect to our sales. We have employees located in offices in Canada, Japan, Taiwan and the People s Republic of China and as such, a portion of our operating expenses are denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. We do not currently hedge against foreign currency rate fluctuations.

Item 4. Controls and Procedures.

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(d) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2007, these disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There have been no changes in our internal control over financial reporting, or in other factors, that occurred during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors.

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

(Dollars in thousands, except per share data)

Our new strategy, targeted at markets demanding superior video and image quality, may not significantly grow revenue and gross margin in a timely manner or at all, which could materially adversely affect our results of operations.

As part of our overall product strategy, we have adopted a new approach which focuses on our core competencies in pixel processing and delivering high levels of video and image quality. While we will continue to invest in further development of our ImageProcessor architecture for the projector market, we are no longer pursuing strategies aimed at the commodity system-on-chip television market. Instead, we are leveraging our advantages in the television market with our pixel enhancement technologies. These technologies are aimed at the increased image and video quality requirements of the next-generation displays, which we expect the market to transition toward over the next twelve to twenty-four months. Additionally, we are taking our technology into new areas beyond our traditional applications, including

technology that is helping drive the convergence of television, media PCs, and internet television and video.
We have designed our new strategy to help us take advantage of expected market trends. However, our expectations may not be accurate, these markets may not develop, or they may take longer to develop than we expect. Additionally, developers of products may not choose to incorporate our products into their products and we cannot assure you that our customers and potential customers will accept our products quickly enough or in sufficient volume to grow revenue and gross profit. A lack of market acceptance or insufficient market acceptance would materially and adversely affect our results of operations.

We may not realize the anticipated benefits from the restructuring efforts announced in 2006 and we may need to initiate additional restructuring efforts in the future.

Phase one of our restructuring plans, announced in April 2006, was designed to improve our breakeven point by reducing manufacturing overhead and operating expenses and focusing on our core business. The second phase was announced in November 2006 and is designed to further reduce operating expenses. This plan includes additional consolidation of our North American operations in order to achieve reduced compensation and rent expenses, while at the same time making critical infrastructure investments in people, process and information systems to improve our operations.

These restructuring plans may take longer to implement than we expect, which could effect the timing and amount of anticipated benefits. In addition, unforeseen circumstances may result in our not being able to obtain the full benefits of the restructuring plans, or our assumptions about the benefits of the plans may prove incorrect or inaccurate, leading to a reduced benefit. Finally, we cannot assure you that future restructuring efforts will not be necessary, or whether the expected benefits from any future restructuring efforts will be attained.

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

As of June 30, 2007, we have $140,000 of 1.75% convertible debentures outstanding. These debt obligations are due in 2024, although the holders of debentures have the right to require us to purchase all or a portion of their debentures on May 15, 2011, May 15, 2014 and May 15, 2019. Additionally, one of the covenants of our debenture agreement can be interpreted such that if we are late with any of our required filings under the Securities Exchange Act of 1934, as amended (1934 Act), and if we fail to effect a cure within 60 days, the holders of the debentures can put the debentures back to the Company, whereby the debentures become immediately due and payable. As a result of our restructuring efforts, the Company has fewer employees to perform day-to-day controls, processes and activities and additionally, certain functions have been transferred to new employees who are not as familiar with procedures, which increase the risk that we will be unable to make timely filings in accordance with the 1934 Act.

These debentures could materially and adversely affect our ability to obtain additional debt or equity financing for working capital, acquisitions or other purposes, limit our flexibility in planning for or reacting to changes in our business, reduce funds available for use in our operations and could make us more vulnerable to industry downturns and competitive pressures. We expect holders of the debentures to require us to purchase all of the outstanding debentures on May 15, 2011, the earliest date allowed by the terms of debentures. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, some of which are beyond our control.

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

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

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

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 video decoding, 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 new products.

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

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

Our future success depends on developers of advanced display products designing our products into their systems. To achieve design wins, we must define and deliver cost-effective, innovative and integrated semiconductors. Once a supplier s products have been designed into a system, the developer may be reluctant to change its source of components due to the significant costs associated with qualifying a new supplier. Accordingly, 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

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choose at any time to discontinue using our products in their designs or product development efforts. If our products are chosen to be incorporated into a developer s products, we may still not realize significant revenues from that developer if that developer s products are not commercially successful or if that developer chooses to qualify, or incorporate the products of, a second source.

Developers can choose at any time to discontinue using our products during the development process or stop ordering our products that have been in volume production which would negatively impact our revenues.

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

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

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

Because of this lengthy development cycle, we will experience delays between the time we incur expenditures for research and development, sales and marketing, and inventory 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 anticipated, we may experience large write-offs of capitalized license fees, product masks or other capitalized or deferred product-related costs that would negatively affect our operating results.

These factors could have a material and adverse effect on our long-term business and results of operations.

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

The year ended December 31, 2004, during which we generated net income of $21,781, was our first and only year of profitability since inception. Since then, we have incurred net losses. On January 1, 2006, we adopted Statement of Financial Accounting Standard No. 123R, *Shared-Based Payments* (SFAS 123R), which requires all share-based payments, including grants of stock options, to be accounted for at fair value and expensed over the service period. The adoption of SFAS 123R had, and will continue to have, a significant adverse impact on our operating results.

In April 2006, we initiated a restructuring plan to improve our breakeven point by reducing manufacturing overhead and operating expenses and focusing on our core business. In November 2006, we initiated an additional restructuring plan to further reduce operating expenses. We cannot be certain these plans will be successful or that we will achieve profitability in the future or, if we do, that we can sustain or increase profitability on a quarterly or annual basis. If we are not profitable in the future, we may be unable to continue our operations.

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

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

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

Fluctuations in our quarterly results could adversely affect the price of our common stock in a manner unrelated to our long-term operating performance. Because our operating results are volatile and difficult to predict, you should not rely on the results of one quarter as an indication of our future performance. Additionally, it is possible that in some future quarter our operating results will fall below the expectations of securities analysts and investors. In this event, the price of our common stock may decline significantly.

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

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

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

To manage any future expansion efforts effectively in a rapidly evolving market, we must be able to maintain and improve our operational and financial systems, train and manage our employee base and attract and retain qualified personnel with relevant experience. We must also manage multiple relationships with customers, business partners, contract manufacturers, suppliers and other third parties. We could spend substantial amounts of time and money in connection with expansion efforts for which we may not realize

any profit. Our systems, procedures or controls may not be adequate to support our operations and we may not be able to expand quickly enough to exploit potential market opportunities. If we do not manage future expansion efforts effectively our operating expenses could increase more rapidly than our revenue, adversely affecting our financial condition and results of operations. For example, in 2005 and 2006, we invested significant amounts in research and development efforts for projects that were ultimately canceled, and for which we will not realize any revenue.

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

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

To date, we have acquired Panstera in January 2001, nDSP in January 2002, Jaldi in September 2002 and Equator in June 2005. In March 2003, we announced the execution of a definitive merger agreement with Genesis Microchip, Inc.; however, the merger was terminated in August 2003, and we incurred $8,949 of expenses related to the transaction. In the third quarter of 2003, we made an investment of $10,000 in Semiconductor Manufacturing International Corporation (SMIC).

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

These and any future acquisitions and investments could result in:

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

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

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

The acquisition of Equator has unfortunately not been as successful as we had hoped. We acquired Equator for an aggregate purchase price of $118,116 and recorded, among other assets, $57,521 in goodwill, $36,800 in acquired developed technology and $4,200 in other acquired intangible assets. However, the Equator technology itself has not proven as useful in our core markets as we had hoped, and thus we have

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recorded impairment losses on goodwill and intangible assets acquired from Equator. Only $6,779 of the developed technology and $344 of the customer relationships intangible assets acquired from Equator remain on our consolidated balance sheet as of June 30, 2007 and only a few of the Equator employees remain employed by us. Additionally, while we are continuing to provide customers with existing products, we are no longer pursuing stand-alone digital media streaming markets that are not core to our business.

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

The markets in which we compete or seek to compete are subject to rapid technological change, frequent new product introductions, changing customer requirements for new products and features, and evolving industry standards. The introduction of new technologies and emergence of new industry standards could render our products less desirable or obsolete, which could harm our business. Examples of changing industry standards include the introduction of high-definition television (HDTV), which includes the ATSC format in the United States, DVB format in Europe and ARIB in Japan, new video decoding technology, such as H.264 or Windows Media 9, new digital receivers and displays with resolutions that have required us to accelerate development of new products to meet these new standards.

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

Our sales are made on the basis of purchase orders rather than long-term purchase commitments. Our customers may cancel or defer purchase orders at any time. This process requires us to make numerous forecast assumptions concerning demand, each of which may introduce error into our estimates. If our customers or we overestimate demand, we may purchase components or have products manufactured that we may not be able to use or sell. As a result, we would have excess inventory, which would negatively affect our operating results. For example, during 2005 and 2006 we overestimated demand for certain inventory which lead to relatively significant charges for obsolete inventory in 2006. Conversely, if our customers or we underestimate demand, or if sufficient manufacturing capacity is not available, we would forego revenue opportunities, lose market share and damage our customer relationships.

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

Selling to distributors and integrators reduces our ability to forecast sales and increases the complexity of our business. Since our distributors act as intermediaries between us and the companies using our products, we must rely on our distributors to accurately report inventory levels and production forecasts. Some of our products are sold to integrators, who then integrate our products into a system that is then sold to an original equipment manufacturer, or OEM. This adds another layer between us and the ultimate source of demand for our products, the consumer. These arrangements require us to manage a more complex supply chain and monitor the financial condition and creditworthiness of our distributors, integrators and customers and make it more difficult for us to predict demand for our products. Our failure to manage one or more of these challenges could result in excess inventory or shortages that could materially impact our operating results or limit the ability of companies using our semiconductors to deliver their products.

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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. This additional level of complexity lengthens the sales cycle and may result in customers selecting competitive products requiring less software integration.

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

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 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 may not be 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 currently have access to certain key technology, owned by independent third parties, through license agreements. In the event of a change in control at the licensor, it may become difficult to attain access to such licensed technology.

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 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 help protect our proprietary technologies. Currently, we hold 65 patents and have 88 patent applications pending for protection of our significant technologies. Competitors in both the U.S. and foreign countries, many of whom have substantially greater resources, may apply for and obtain patents that will prevent, limit or interfere with our ability to make and sell our products, or develop similar technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. In addition, we provide the computer programming code for our software to selected customers in connection with their product development efforts, thereby increasing the risk that customers will misappropriate our proprietary software.

We 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.

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 also could force us to do one or more of the following:

- stop selling products using technology that contains the allegedly infringing intellectual property;

- attempt to obtain a license to the relevant intellectual property, which may not be available on reasonable terms or at all;

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

- pay damages for past infringement claims that are determined to be valid or which are arrived at in settlement of such litigation or threatened litigation.

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

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

The manufacture of semiconductors is a complex process and it is often difficult for semiconductor foundries to produce semiconductors free of defects. Because many of our products are more highly integrated than other semiconductors and incorporate mixed analog and digital signal processing and embedded memory technology, they are even more difficult to produce without defects. Despite testing by both our customers and us, errors or performance problems may be found in existing or new semiconductors and software.

The ability to manufacture products of acceptable quality depends on both product design and manufacturing process technology. Since defective products can be caused by 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 costs and delays in the availability of our products.

For example, we have experienced field failures of our semiconductors in certain customer system applications that required us to institute additional testing. As a result of these field failures, we incurred warranty costs due to customers returning potentially affected products. Our customers have also experienced delays in receiving product shipments from us that resulted in the loss of revenue and profits.

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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. Shipment of defective products may harm our reputation with customers, and result in loss of market share or failure to achieve market acceptance.

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

We do not own or operate a semiconductor fabrication facility and we do not have the resources to manufacture our products internally. We contract with third-party foundries for wafer fabrication and other manufacturers for assembly and testing of our products. Our requirements represent only a small portion of the total production capacity of our contract manufacturers, who have in the past re-allocated capacity to other customers even during periods of high demand for our products. We expect this may occur again in the future. We have limited control over delivery schedules, quality assurance, manufacturing yields, potential errors in manufacturing and production costs. We do not have long-term supply contracts with our third-party manufacturers so they are not obligated to supply us with products for any specific period of time, quantity or price, except as may be provided in a particular purchase order. From time to time, our contract manufacturers increase prices charged to produce our products with little notice.

If we are unable to obtain our products from our contract manufacturers on schedule, our ability to satisfy customer demand will be harmed, and revenue from the sale of products may be lost or delayed. If orders for our products are cancelled, expected revenues would not be realized. In addition, if the price charged by our contract manufacturers increases we will be required to increase our prices, which could harm our competitiveness. For example, in the fourth quarter of 2005, one of our contract manufacturers experienced temporary manufacturing delays due to unexpected manufacturing process problems, which caused delays in delivery of our products making it difficult for us to satisfy our customer demand.

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

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

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

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

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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. A portion of our products use embedded DRAM technology and the required manufacturing processes will only be available for a limited time. We also utilize 0.18um, 0.15um and 0.13um standard logic processes, which may only be available for the next five to seven years. Once a manufacturer makes the decision to retire a manufacturing process, notice is generally given to its customers. Customers will then either retire the affected part or develop a new version of the part that can be manufactured 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 and takes significant time. For example in the third quarter of 2006, one of our third-party foundries discontinued the manufacturing process used to produce one of our products. While we were able to place last time buy orders, we under estimated demand for this part. As a result, we had to pay additional amounts to the foundry to restart production and we were unable to fulfill customer orders in a timely manner.

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

We are building many of our products on a customer owned tooling basis, also known in the semiconductor industry as COT, where we directly contract the manufacture of wafers and assume the responsibility for the assembly and testing of our products. As a result, we are subject to increased risks arising from wafer manufacturing yields and risks associated with coordination of the manufacturing, assembly and testing process. Poor product yields would result in higher product costs, which could make our products uncompetitive if we increased our prices or result in low gross profit margins if we did not increase our prices.

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

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

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

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

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. In addition, because of the highly technical nature of our business, the loss of key engineering personnel could delay

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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. Currently, this risk has increased as we go through restructuring efforts to consolidate several of our North American operating sites and transition key processes and technical expertise to our Shanghai, China design center. For example, in the last six months we have been or are in the process of replacing certain officers of the Company, including the Chief Executive Officer, Chief Financial Officer and Chief Technology Officer, as we change the strategic direction of the Company and consolidate into a smaller number of operating sites. In addition during 2006, we experienced difficulties in hiring and retaining qualified engineers in our Shanghai design center. If we do not succeed in hiring and retaining employees with appropriate qualifications, our product development efforts, revenues and business could be seriously harmed.

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

We have historically used stock options and other forms of share-based payment awards as key components of our total compensation program in order to retain employees and directors and provide competitive compensation and benefit packages. In accordance with SFAS 123R, we began recording charges to earnings for share-based payments in the first quarter of 2006. As a result, we have incurred and will continue to incur increased compensation costs associated with our share-based programs, making it more expensive for us to grant share-based payment awards to employees, officers and directors in the future. We continuously review our equity compensation strategy in light of current regulatory and competitive environments and consider changes to the program as appropriate. In addition, to the extent that SFAS 123R makes it more expensive to grant stock options or to continue to have an employee stock purchase plan, we may decide to incur cash compensation costs in the future. Actions that we take to reduce stock-based compensation expense that might be more aggressive than actions implemented by our competitors, could make it difficult to attract, retain and motivate employees, which could adversely affect our competitive position as well as our business and results of operations.

As a result of reviewing our equity compensation strategy, in 2006 we reduced the total number of options granted to employees and the number of employees who receive share-based payment awards. Additionally, in October 2006, our shareholders approved a stock option exchange program whereby eligible employees could elect to exchange eligible outstanding options for new options at the then current market price of our common stock and at a rate of 4-to-1. Effective December 4, 2006, 184 employees surrendered 1,739,920 eligible options in exchange for 434,980 new stock options. The new options have an exercise price of $2.49 per share, have a 7-year term and vest over 18 months. While the goal of this program was to aid in the retention of key employees, it is unknown what effect, if any, it will have on our ability to retain these employees.

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

We are, and will continue to be, dependent on a limited number of distributors and customers for a substantial portion of our revenue. Sales to distributors represented 63% and 59% of total revenue for the three and six month periods ended June 30, 2007, respectively, and 52% and 46% for the years ended December 31, 2006 and 2005, respectively. Sales to Tokyo Electron Device, or TED, our Japanese distributor, represented 36% and 34% of total revenue for the three and six month periods ended June 30,

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2007, respectively, and 26% and 22% for the years ended December 31, 2006 and 2005, respectively. Revenue attributable to our top five end customers represented 46% and 47% of total revenue for the three and six month periods ended June 30, 2007, respectively, and 39% and 34% for the years ended December 31, 2006 and 2005, respectively. As a result of these distributor and end customer concentrations, any one of the following factors could significantly impact our revenue:

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

- a decision by one or more significant end customer 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 revenue from a relatively small number of customers.

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

As of June 30, 2007 and December 31, 2006, we had two and four customers, respectively, that each represented 10% or more of accounts receivable. The failure of any of these customers to pay these balances or any other customer to pay their outstanding balance would result in an operating expense and reduce our cash flows.

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

Sales outside the U.S. accounted for approximately 95% of total revenue for the three and six month periods ended June 30, 2007, and 96% for the years ended December 31, 2006 and 2005. We anticipate that sales outside the U.S. will continue to account for a substantial portion of our revenue in future periods. In addition, customers who incorporate our products into their products sell a substantial portion of their products outside of the U.S., and all of our products are manufactured outside of the U.S. We are, therefore, subject to many international risks, including, but not limited to:

- increased difficulties in managing international distributors and manufacturers of our products and components due to varying time zones, languages and business customs;

- foreign currency exchange fluctuations such as the devaluation in the currencies of Japan, People s Republic of China (PRC), Taiwan or Korea that could result in an increase in our operating expenses and cost of procuring our semiconductors;

- potentially adverse tax consequences;

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

- political and economic instability, particularly in the PRC, Japan, Taiwan, or Korea;

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

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

- increased risk of internal control weaknesses for key processes transferred to our Asian operations;

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

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

outbreaks of SARS, bird flu or other pandemics in the PRC or other parts of Asia; and

difficulties in collecting outstanding accounts receivable balances.

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

A substantial, and potentially increasing, portion of our products are manufactured by foundries located in the PRC. In addition, approximately 71% of our employees are located in this area and we have an investment of $10,000 in SMIC, located in Shanghai, China. Disruptions from natural disasters, health epidemics (including new outbreaks of SARS or bird flu) and political, social and economic instability may affect the region, and would have a negative impact on our results of operations. In addition, the economy of the PRC differs from the economies of many countries in respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position, among others. In the past, the economy of the PRC has been primarily a planned economy subject to state plans. Since the entry of the PRC into the World Trade Organization in 2002, the PRC government has been reforming its economic and political systems. These reforms have resulted in significant economic growth and social change. We cannot be assured that the PRC s policies for economic reforms will be consistent or effective. Our results of operations and financial position may be harmed by changes in the PRC s political, economic or social conditions.

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

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

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

We are subject to numerous environmental laws and regulations. Compliance with current or future environmental laws and regulations could require us to incur substantial expenses which could harm our business, financial condition and results of operations. For example, during 2006 the European Parliament enacted the Restriction on Use of Hazardous Substances Directive, or RoHS Directive, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead. In 2006, we incurred increased inventory provisions of $3,760 as a result of the enactment of RoHS, which adversely affected our gross profit margin. Additionally during 2006, the European Parliament enacted the Waste Electrical and Electronic Equipment Directive, or WEEE Directive, which makes producers of electrical and electronic equipment financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. We have, and will continue to, work with our suppliers and customers to ensure that products that our products are compliant with the

RoHS and WEEE Directives. Failure to comply with such legislation could result in our customers refusing to purchase our products and subject us to significant monetary penalties in connection with a violation, both of which could have a materially adverse effect on our business, financial condition and results of operations. These environmental laws and regulations could become more stringent over time, imposing even greater compliance costs and increasing risks and penalties associated with violations, which could seriously harm our business, financial condition and results of operation. There can be no assurance that violations of environmental laws or regulations will not occur in the future as a result of our inability to obtain permits, human error, equipment failure or other causes.

Risks Related to Our Industry

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

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

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

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

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

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

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

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

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

Other Risks

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

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

- our board of directors is authorized, without prior shareholder approval, to change the size of the board. Our articles of incorporation provide that if the board is increased to eight or more members, the board will be divided into three classes serving staggered terms, which would make it more difficult for a group of shareholders to quickly change the composition of our board;

- our board of directors is authorized, without prior shareholder approval, to create and issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us or change our control, commonly referred to as blank check preferred stock;

- members of our board of directors can only be removed for cause;

the board of directors may alter our bylaws without obtaining shareholder approval; and

shareholders are required to provide advance notice for nominations for election to the board of directors or for proposing matters to be acted upon at a shareholder meeting.

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

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

actual or anticipated fluctuations in our operating results;

actual reduction in our operating results due to the adoption of SFAS 123R, which requires, among other things, the expensing of stock options which began January 1, 2006;

changes in expectations as to our future financial performance;

changes in financial estimates of securities analysts;

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

the operating and stock price performance of other comparable companies;

announcements of future expectations by our customers;

changes in market valuations of other technology companies; and

inconsistent trading volume levels of our common stock.

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

In addition, over the past six months, our common stock has traded at or below $2 per share. If our common stock trades below $1 per share, we will not satisfy the minimum listing standards of the NASDAQ Global Market, and may become subject to delisting. The delisting of our common stock would significantly disrupt the ability of investors to trade our securities and would significantly affect the value and liquidity of our securities. Delisting may also preclude us from using certain state securities laws exemptions, which could make it more difficult and expensive for us to raise capital in the future.

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

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

For example, as of June 30, 2007 we have $140,000 of unsecured convertible bonds outstanding that have a put date of May 15, 2011, with $125,216 in cash and marketable securities resulting in a net cash deficit position. There can be no guarantee that the Company will be able to generate sufficient cash flows from operations in the future to refinance or service the potential put option on the convertible bonds.

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

We are spending a significant amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission rules and regulations and NASDAQ Global Market rules. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal control over financial reporting, and attestation of the effectiveness of our internal control over financial reporting by our independent registered public accounting firm. The process of documenting and testing our controls over financial reporting has required that we hire additional personnel and outside services and has resulted in additional accounting and legal expenses. While we invested significant time and money in our effort to evaluate and test our internal control over financial reporting, a material weakness was identified in our internal control over financial reporting in 2004. In addition, there are inherent limitations to the effectiveness of any system of internal controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can provide only reasonable assurance of achieving their control objectives.

As part of our restructuring efforts to reduce operating expenses and to support migrating engineering design capability to Asia, we have transitioned key finance and information technology infrastructure and technical expertise to our Shanghai site which may raise the risk of weakness in our internal control environment.

Item 4. Submission of Matters to a Vote of Security Holders.

The 2007 Annual Meeting of Shareholders of Pixelworks, Inc. was held on May 22, 2007 to conduct the following items of business:

1. To elect six Directors to serve for the following year or until their successors are elected;

2. To ratify the appointment of KPMG LLP as Pixelworks independent registered public accounting firm for the current fiscal year; and

3. To transact any other business that properly came before the meeting.

The following nominees were elected to serve on the board of directors by the votes and for terms indicated below:

Nominee	For	Withheld	Term Ending
Allen H. Alley	39,337,452	3,099,925	2008
Mark A. Christensen	39,419,095	3,018,282	2008
James R. Fiebiger	39,495,827	2,941,550	2008
C. Scott Gibson	39,423,423	3,013,954	2008
Daniel J. Heneghan	39,422,931	3,014,446	2008
Bruce A. Walicek	40,031,016	2,406,361	2008

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The proposal to ratify the appointment of KPMG LLP as Pixelworks independent registered public accounting firm for the current fiscal year was approved and received the following votes:

	No. of Votes
For	40,887,247
Against	1,376,268
Abstain	173,862

There were no other matters of business that properly came before the meeting that were voted upon.

Item 6. Exhibits.

10.1 Restricted Stock Award Agreement, dated May 3, 2008, between Pixelworks, Inc. and Hans H. Olsen. +

10.2 Offer Letter, dated June 22, 2007, between Pixelworks, Inc. and Steven L. Moore. +

10.3 Severance Agreement, dated June 22, 2007, between Pixelworks, Inc. and Steven L. Moore. +

31.1 Certification of Chief Executive Officer.

31.2 Certification of Chief Financial Officer.

32.1* Certification of Chief Executive Officer.

32.2* Certification of Chief Financial Officer.

+ Indicates a management contract or compensation arrangement.

* Exhibits 32.1 and 32.2 are being furnished and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liability of that section, nor shall such exhibits be deemed to be

incorporated by reference in any registration statement or other document filed under the Securities Act of 1933, as amended, or the Exchange Act, except as otherwise stated in such filing.

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SIGNATURE

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

PIXELWORKS, INC.

Dated: August 9, 2007

/s/ Steven L. Moore

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