

BSQUARE CORP /WA  
Form 10-Q  
May 05, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-27687

**BSQUARE CORPORATION**

(Exact name of registrant as specified in its charter)

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<b>Washington</b> (State or other jurisdiction of incorporation or organization)	<b>91-1650880</b> (I.R.S. Employer Identification No.)
<b>110 110<sup>th</sup> Avenue NE, Suite 200,</b> <b>Bellevue WA</b> (Address of principal executive offices)	<b>98004</b> (Zip Code)
<b>(425) 519-5900</b> (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 past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input checked="" type="checkbox"/>

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

The number of shares of common stock outstanding as of April 30, 2011: 10,595,060

**Table of Contents**

**BSQUARE CORPORATION**

**FORM 10-Q**

**For the Quarterly Period Ended March 31, 2011**

**TABLE OF CONTENTS**

		<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>		
Item 1	<u>Financial Statements</u>	3
Item 2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	21
Item 4	<u>Controls and Procedures</u>	21
<b><u>PART II. OTHER INFORMATION</u></b>		
Item 1A	<u>Risk Factors</u>	21
Item 6	<u>Exhibits</u>	21
EXHIBIT 10.18(e)		
EXHIBIT 31.1		
EXHIBIT 31.2		
EXHIBIT 32.1		
EXHIBIT 32.2		

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****BSQUARE CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share amounts)

	March 31, 2011 (Unaudited)	December 31, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 8,304	\$ 10,814
Short-term investments	12,105	11,329
Accounts receivable, net of allowance for doubtful accounts of \$251 at March 31, 2011 and \$290 at December 31, 2010	15,792	14,128
Deferred tax assets	127	145
Prepaid expenses and other current assets	688	403
Total current assets	37,016	36,819
Long-term investment	122	122
Equipment, furniture and leasehold improvements, net	643	653
Intangible assets, net	965	1,049
Restricted cash	875	875
Deferred tax assets	2,392	2,495
Other non-current assets	93	83
Total assets	\$ 42,106	\$ 42,096
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Third-party software fees payable	\$ 11,148	\$ 11,132
Accounts payable	541	261
Accrued compensation	1,636	2,497
Other accrued expenses	1,436	1,467
Deferred revenue	1,333	1,417
Total current liabilities	16,094	16,774
Deferred rent	223	240
Shareholders' equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 10,523,623 shares issued and outstanding at March 31, 2011 and 10,415,541 shares issued and outstanding at December 31, 2010	125,282	124,716
Accumulated other comprehensive loss	(488)	(445)
Accumulated deficit	(99,005)	(99,189)
Total shareholders' equity	25,789	25,082
Total liabilities and shareholders' equity	\$ 42,106	\$ 42,096

See notes to condensed consolidated financial statements.

**Table of Contents**

**BSQUARE CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts) (Unaudited)

	Three Months Ended March 31,	
	2011	2010
Revenue:		
Software	\$ 18,749	\$ 12,012
Service	7,259	4,933
Total revenue	26,008	16,945
Cost of revenue:		
Software	15,269	9,645
Service	5,489	6,118
Total cost of revenue	20,758	15,763
Gross profit	5,250	1,182
Operating expenses:		
Selling, general and administrative	3,931	3,136
Research and development	914	907
Total operating expenses	4,845	4,043
Income (loss) from operations	405	(2,861)
Other income (expense)	8	(488)
Income (loss) before income taxes	413	(3,349)
Income tax expense	(229)	(91)
Net income (loss)	\$ 184	\$ (3,440)
Basic income (loss) per share	\$ 0.02	\$ (0.34)
Diluted income (loss) per share	\$ 0.02	\$ (0.34)
Shares used in calculation of income per share:		
Basic	10,430	10,127
Diluted	11,704	10,127

See notes to condensed consolidated financial statements.

**Table of Contents****BSQUARE CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands) (Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 184	\$ (3,440)
<b>Adjustments to reconcile net income (loss) to net cash used by operating activities:</b>		
Realized loss on investments		510
Depreciation and amortization	214	237
Stock-based compensation	500	160
Deferred income tax benefit	121	
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable, net	(1,664)	(947)
Prepaid expenses and other assets	(294)	(35)
Third-party software fees payable	16	1,931
Accounts payable and accrued expenses	(611)	126
Deferred revenue	(84)	(482)
Deferred rent	(17)	(17)
<b>Net cash used by operating activities</b>	<b>(1,635)</b>	<b>(1,957)</b>
<b>Cash flows from investing activities:</b>		
Purchases of equipment and furniture	(120)	(38)
Proceeds from maturities of short-term investments	5,600	
Maturities of investments		25
Proceeds from reduction of restricted cash		25
Purchases of short-term investments	(6,377)	
<b>Net cash provided by (used in) investing activities</b>	<b>(897)</b>	<b>12</b>
<b>Cash flows from financing activities - proceeds from exercise of stock options</b>	<b>66</b>	<b>8</b>
Effect of exchange rate changes on cash	(44)	2
<b>Net decrease in cash and cash equivalents</b>	<b>(2,510)</b>	<b>(1,935)</b>
Cash and cash equivalents, beginning of period	10,814	12,918
<b>Cash and cash equivalents, end of period</b>	<b>\$ 8,304</b>	<b>\$ 10,983</b>

See notes to condensed consolidated financial statements.

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**Table of Contents**

**BSQUARE CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2011**

**(Unaudited)**

**1. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements for BSQUARE Corporation ( **BSQUARE** ), pursuant to the rules and regulations of the Securities and Exchange Commission for interim financial reporting and include the accounts of BSQUARE Corporation and its subsidiaries. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles ( **GAAP** ) have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of March 31, 2011 and our operating results and cash flows for the three months ended March 31, 2011 and 2010. The accompanying financial information as of December 31, 2010 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained our Annual Report on Form 10-K for the year ended December 31, 2010. All intercompany balances have been eliminated.

***Reclassification of Previously Issued Financial Statements***

We have reclassified certain changes in operating liabilities on our condensed consolidated statement of cash flows for the three months ended March 31, 2010 related to fees payable to third-party software suppliers such as Microsoft Corporation ( **Microsoft** ) given their significance. These fees were previously included in accounts payable and other accrued expenses.

***Recently Issued Accounting Standards***

In January 2010, the Financial Accounting Standards Board ( **FASB** ) issued a new accounting standards update for fair value measurements and disclosures. A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 and describe the reasons for the transfers. A reporting entity should separately disclose information about purchases, sales, issuances and settlements for Level 3 reconciliation disclosures. The new disclosures and clarifications of existing disclosures are effective for financial statements issued interim or annual financial periods ending after December 15, 2009, with the exception for the reconciliation disclosures for Level 3, which are effective for financial statements issued interim or annual financial periods ending after December 15, 2010. The adoption of the new accounting standards update did not have a material impact on our consolidated results of operations, financial condition or financial disclosures.

***Income or Loss Per Share***

Basic income or loss per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as options, restricted stock awards ( **RSAs** ) and restricted stock units ( **RSUs** ). **RSAs** are considered outstanding and included in the computation of basic income or loss per share when underlying restrictions expire and the awards are no longer forfeitable. **RSUs** are considered outstanding and included in the computation of basic income or loss per share only when vested. Diluted income or loss per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock and if-converted method. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive.



**Table of Contents****2. Investments**

Investments consist of the following (in thousands):

	March 31, 2011	December 31, 2010
<b>Short-term investments:</b>		
U.S. agency securities	2,765	2,250
Municipal securities	450	450
Corporate commercial paper	1,760	2,749
Foreign government bonds	766	775
Corporate debt securities	6,364	5,105
<b>Total short-term investments</b>	<b>12,105</b>	<b>11,329</b>
Long-term investment auction rate security ( ARS )	122	122
<b>Total investments</b>	<b>\$ 12,227</b>	<b>\$ 11,451</b>

We record our investments at fair value. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. A three-tier fair value hierarchy is established as a basis for considering such assumptions and for inputs used in the valuation methodologies in measuring fair value:

- Level 1: Quoted prices in active markets for identical assets or liabilities.
- Level 2: Directly or indirectly observable market-based inputs or unobservable inputs used in models or other valuation methodologies.
- Level 3: Unobservable inputs that are not corroborated by market data. The inputs require significant management judgment or estimation.

Our short-term investments consist entirely of marketable securities classified as available for sale. All short-term investments were valued based on quoted market prices of similar instruments and other significant inputs derived from, or corroborated by, observable market data.

Due to the lack of observable market quotes on our ARS, we have estimated the fair value using inputs including the underlying financial condition and credit quality of the issuer, the maturity of the security, and secondary market bid levels of similar and identical securities. Based on these inputs, we estimated the fair value of our ARS to be \$122,000 as of March 31, 2011, compared to a par value of \$500,000. We have classified our ARS as a long-term investment as of March 31, 2011 due to our uncertainty as to when this security will be sold. Our ARS was our only asset measured and recorded at fair value on a recurring basis, using significant unobservable inputs (Level 3), and there was no change in the account balance from December 31, 2010 to March 31, 2011.

As of March 31, 2011 and December 31, 2010 our investments primarily consisted of U.S. and foreign government and agency securities, and other investment grade securities. Such amounts are recorded at fair value. We had \$1,000 of unrealized losses on our investments as of March 31, 2010, and \$1,000 at December 31, 2010. The following table summarizes, by major security type, our assets that are measured at fair value on a recurring basis, other than cash and cash equivalents and restricted cash, and are categorized using the fair value hierarchy as of March 31, 2011(in thousands):

	March 31, 2011			Total
	Quoted Prices in Active Markets for	Direct or Indirect Observable	Significant Unobservable	

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	Identical Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)	
<b>Short-term investments:</b>				
U.S. agency securities		2,765		2,765
Municipal securities		450		450
Corporate commercial paper		1,760		1,760
Foreign government bonds		766		766
Corporate debt securities		6,364		6,364
Long-term investment ARS			122	122
<b>Total</b>	<b>\$</b>	<b>\$ 12,105</b>	<b>\$</b>	<b>\$ 12,227</b>

**Table of Contents**

The following table summarizes, by major security type, our assets that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy as of December 31, 2010 (in thousands):

	December 31, 2010			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Short-term investments:				
U.S. agency securities		2,250		2,250
Municipal securities		450		450
Corporate commercial paper		2,749		2,749
Foreign government bonds		775		775
Corporate debt securities		5,105		5,105
Long-term investment ARS			122	122
Total	\$	\$ 11,329	\$ 122	\$ 11,451

**3. Intangible Assets**

Intangible assets relate to customer relationships, tradenames, trademarks and technology that we acquired from TestQuest in November 2008. The following table presents the gross carrying value of the acquired intangible assets and accumulated amortization (in thousands):

	March 31, 2011	December 31, 2010
Gross carrying value of the acquired intangible assets subject to amortization	\$ 2,158	\$ 2,158
Accumulated amortization	(1,193)	(1,109)
Net book value	\$ 965	\$ 1,049

**Table of Contents**

As of March 31, 2011, 83% of the gross carrying value and 75% of the net book value represented acquired technology. Amortization expense was \$83,000 and \$128,000 for the three months ended March 31, 2011 and 2010, respectively. Amortization in future periods is expected to be as follows (in thousands):

Remainder of 2011	\$ 250
2012	330
2013	278
2014	37
2015	36
Thereafter	34
<b>Total</b>	<b>\$ 965</b>

**4. Shareholders' Equity****Stock Options**

We have a stock plan (the Plan) under which stock options may be granted with a fixed exercise price that is typically fair market value on the date of grant. These options have a term of up to 10 years and vest over a predetermined period, generally four years. Incentive stock options granted under the Plan may only be granted to our employees, have a term of up to 10 years, and must be granted with an exercise price equal to the fair market value of our stock on the date of grant. The Plan also allows for awards of stock appreciation rights, restricted and unrestricted stock awards, and restricted stock units. The Plan allows for an automatic annual increase in the number of shares reserved for issuance under the Plan. Such automatic annual increase is in an amount equal to the lesser of: (i) four percent of our outstanding shares at the end of the previous fiscal year, (ii) an amount determined by our Board of Directors, or (iii) 375,000 shares.

**Stock-Based Compensation**

The estimated fair value of stock based awards is recognized as compensation expense over the vesting period of the award, net of estimated forfeitures. We estimate forfeitures based on historical experience and expected future activity. The fair value of restricted stock awards and restricted stock units is determined based on the number of shares granted and the quoted price of our common stock on the date of grant. The fair value of stock option awards are estimated at the grant date based on the fair value of each vesting tranche as calculated by the Black-Scholes-Merton (BSM) option-pricing model. The BSM model requires various highly judgmental assumptions including expected volatility and option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. The fair values of our equity awards, primarily stock option grants, were estimated with the following weighted average assumptions:

	Three Months Ended	
	March 31,	
	2011	2010
Dividend yield	0%	0%
Expected life	3.9 years	4.3 years
Expected volatility	74%	71%
Risk-free interest rate	1.6%	2.0%

The impact on our results of operations of recording stock-based compensation expense for the three months ended March 31, 2011 and 2010 was as follows (in thousands, except per share amounts):

Three Months Ended	
March 31,	
2011	2010

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Cost of revenue service	\$ 219	\$ 73
Selling, general and administrative	239	78
Research and development	42	9
Total stock-based compensation expense	\$ 500	\$ 160
Per diluted share	\$ 0.04	\$ 0.02

**Table of Contents****Stock Option Activity**

The following table summarizes stock option activity for the three months ended March 31, 2011:

<b>Stock Options</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (in years)</b>	<b>Aggregate Intrinsic Value</b>
Balance at January 1, 2011	1,942,723	\$ 3.66		
Granted at fair value	312,000	8.61		
Exercised	(86,366)	3.14		
Forfeited	(6,000)	2.57		
Expired	(3,962)	27.96		
Balance at March 31, 2011	2,158,395	\$ 4.35	4.56	\$ 6,757,000
Vested and expected to vest at March 31, 2011	2,029,772	\$ 4.25	4.50	\$ 6,504,000
Exercisable at March 31, 2011	1,477,470	\$ 3.81	4.16	\$ 5,205,000

At March 31, 2011, total compensation cost related to stock options granted to employees but not yet recognized was \$1,315,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.72 years.

The following table summarizes certain information about stock options for the three months ended March 31, 2011:

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Weighted average grant-date fair value for options granted during the period	\$ 4.75	\$ 1.54
Options in-the-money at March 31	1,443,468	321,814
Aggregate intrinsic value of options exercised	\$ 542,000	\$ 2,000

The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of our common stock for the number of options that were in-the-money at period end or that were exercised during the period. We issue new shares of common stock upon exercise of stock options.

**Restricted Stock Award Activity**

The following table summarizes restricted stock award activity for the three months ended March 31, 2011:

<b>Number of Shares</b>	<b>Weighted Average Grant-Date Fair Value Per Share</b>
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Unvested at December 31, 2010	42,000	\$	3.38
Granted	10,500		8.18
Vested	(10,500)		2.44
Forfeited			
Unvested at March 31, 2011	42,000	\$	4.81
Expected to vest after March 31, 2011	36,960	\$	4.81

At March 31, 2011, total compensation cost related to restricted stock awards granted but not yet recognized was \$116,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 0.5 years. Currently, only our Board of Directors receives restricted stock awards.

**Table of Contents****Restricted Stock Unit Activity**

The following table summarizes restricted stock unit activity for the three months ended March 31, 2011:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2010	221,776	\$ 5.27
Granted	146,182	4.23
Vested	(70,264)	3.23
Forfeited	(4,740)	5.49
Unvested at March 31, 2011	292,954	\$ 5.23
Expected to vest after March 31, 2011	264,434	\$ 5.23

At March 31, 2011, total compensation cost related to restricted stock units granted but not yet recognized was \$1,001,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.0 years.

**Common Stock Reserved for Future Issuance**

The following table summarizes our shares of common stock reserved for future issuance at March 31, 2011 and December 31, 2010:

	March 31, 2011	December 31, 2010
Stock options outstanding	2,158,395	1,942,723
Restricted stock units outstanding	292,954	221,776
Stock options available for future grant	456,699	540,419
Common stock reserved for future issuance	2,908,048	2,704,918

**5. Other Comprehensive Income or Loss**

Comprehensive income or loss refers to net income or loss and other revenue, expenses, gains and losses that, under generally accepted accounting principles, are recorded as an element of shareholders' equity but are excluded from the calculation of net income or loss.

The changes in the components of other comprehensive income or loss are as follows (in thousands):

	Three Months ended March 31,	
	2011	2010
Net unrealized gain (loss) on investments	\$ (1)	\$ 308
Foreign currency translation gain (loss)	(42)	1
Other comprehensive income (loss)	\$ (43)	\$ 309

**6. Commitments and Contingencies**



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Our principal commitments consist of obligations outstanding under operating leases, which expire through 2014. We have lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Chanhassen, Minnesota; Dallas, Texas; Taipei, Taiwan; Beijing, China, Seoul, Korea and Nishi-Shinjuku, Japan. We also lease office space in Akron.

Under the terms of our corporate headquarters lease signed in February 2004, if we default under the lease, the landlord has the ability to demand payment for cash payments forgiven in 2004. The amount of the forgiven payments for which the landlord can demand repayment was \$819,000 at March 31, 2011.

Rent expense was \$382,000 for the three months ended March 31, 2011 and \$394,000 for the three months ended March 31, 2010.

**Table of Contents**

As of March 31, 2011, we had \$875,000 pledged as collateral for a bank letter of credit under the terms of our headquarters facility lease. The pledged cash supporting the outstanding letter of credit is recorded as restricted cash.

Future operating lease commitments are as follows by calendar year (in thousands):

2011	\$ 995
2012	1,200
2013	1,089
2014	770
Thereafter	
 Total commitments	 \$ 4,054

**7. Information about Geographic Areas**

Our chief operating decision-makers (i.e., chief executive officer, and certain of his direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable by our chief operating decision-makers, or anyone else, for operations, operating results, or planning for levels or components below the consolidated unit level. Accordingly, we consider ourselves to be in a single reporting segment and operating unit structure.

Revenues by geography are based on the billing address of the customer. The following table sets forth revenues and long-lived assets by geographic area (in thousands):

	Three Months Ended	
	March 31,	
	2011	2010
<b>Total revenue:</b>		
North America	\$ 19,358	\$ 15,434
Asia	5,682	1,130
Other foreign	968	381
 <b>Total revenue</b>	 <b>\$ 26,008</b>	 <b>\$ 16,945</b>
	March 31,	December 31,
	2011	2010
<b>Long-lived assets:</b>		
North America	\$ 1,548	\$ 1,608
Asia	60	94
 Total long-lived assets	 \$ 1,608	 \$ 1,702

**Table of Contents**

**8. Significant Risk Concentrations**

***Significant Customer***

No customer accounted for 10% or more of total revenue for the three months ended March 31, 2011. Ford Motor Company ( Ford ) accounted for \$2.3 million, or 14%, of total revenue for the three months ended March 31, 2010. No other customer accounted for 10% or more of total revenue for the three months ended March 31, 2010.

Ford had an accounts receivable balance of \$2.5 million, or 16% of total accounts receivable, as of March 31, 2011, \$1.7 million of which remained outstanding as of the filing of this Quarterly Report on Form 10-Q for the three months ended March 31, 2011. No other customer accounted for 10% or more of total accounts receivable as of March 31, 2011. No customer accounted for 10% or more of total accounts receivable as of December 31, 2010.

***Significant Supplier***

We have an OEM Distribution Agreement ( ODA ) with Microsoft Corporation ( Microsoft ) which enables us to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico which expires on June 30, 2011. We also have ODAs with Microsoft which allow us to sell Microsoft Windows Mobile operating systems, and related applications such as Office Mobile, on a world-wide basis, which expire on November 30, 2011.

Software sales under these agreements constitute a significant portion of our software revenue and total revenue. These agreements are typically renewed annually or semi-annually; however there is no automatic renewal provision in any of these agreements. Further, these agreements can be terminated unilaterally by Microsoft at any time. Microsoft currently offers a rebate program in conjunction with our ODA to sell Microsoft Windows Embedded operating systems in which we earn money for achieving certain predefined objectives. Under this rebate program we earned \$206,000 and \$186,000 during the three months ended March 2011 and 2010 respectively, which is accounted for as a reduction in software cost of revenue.

We signed an additional ODA with Microsoft in April 2011 which enables us sell Microsoft Windows Embedded operating systems in countries comprising the European Union and the European Free Trade Association although our focus will be on the UK and Germany. This agreement will expire in June 2011, consistent with our other ODA with Microsoft for Windows Embedded operating systems.

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## **Table of Contents**

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

As used in this Quarterly Report on Form 10-Q, we, us, our and the Company refer to BSQUARE Corporation, a Washington corporation, and its subsidiaries.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and related notes. Some statements and information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended, (the Exchange Act). In some cases, readers can identify forward-looking statements by terms such as may, will, should, expect, plan, intend, forecast, anticipate, believe, estimate, predict, potential, continue, or the negative of these terms or other comparable terminology, which are used are meant to signify the statement as forward-looking. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and situations that are difficult to predict and that may cause our own, or our industry's actual results, to be materially different from the future results that are expressed or implied by these statements. Accordingly, actual results may differ materially from those anticipated or expressed in such statements as a result of a variety of factors, including those discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2010 entitled Risk Factors, as well as those contained from time to time in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

#### **Overview**

We provide software solutions to companies that develop smart, connected devices and to companies that assist others in developing smart, connected devices. A smart, connected device is a dedicated purpose computing device that typically has a display, runs an operating system and may be connected to a network via a wired or wireless connection. Examples of smart devices include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, tablets, handheld data collection devices, personal media players, smart phones and devices targeted at automotive applications. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile. However, we also provide software solutions to customers developing devices utilizing other operating systems such as Android and Linux.

We have been providing software solutions to the smart device marketplace since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs) and enterprises, as well as silicon vendors (SVs) and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales to the aforementioned customer categories. In the case of enterprises, our customers include those which develop, market and distribute smart devices on their own behalf as well as those that purchase devices from OEMs or ODMs and require additional device software or testing. The software solutions we provide are utilized and deployed throughout various phases of our customers' device life cycle, including design, development, customization, quality assurance and deployment.

#### **Critical Accounting Judgments**

##### *Use of Estimates*

The preparation of Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from these estimates. On an ongoing basis, we evaluate our estimates, including those related to the allowance for doubtful accounts, percentage of completion on fixed price service contracts, fair values of financial instruments, deferred tax asset allowances, intangible assets, useful lives and fair value of intangible assets and property and equipment, fair values of stock-based awards and income taxes, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

##### *Revenue Recognition*

We recognize revenue from software and engineering service sales when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the selling price is fixed or determinable; and collectability is reasonably assured. Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and time records are generally used to verify delivery. We assess whether the



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**Table of Contents**

selling price is fixed or determinable based on the contract and/or customer purchase order and payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history. Periodically, we will begin work on engineering service engagements prior to having a signed contract and, in some cases, the contract is signed in a quarter after which service delivery costs are incurred. We do not defer costs associated with these non-contracted engagements.

We recognize software revenue upon shipment provided that no significant obligations remain on our part, substantive acceptance conditions, if any, have been met and the other revenue recognition criteria have been met. Service revenue from time and materials contracts, and training service agreements, is recognized as services are performed. Certain fixed-price service agreements, and time and materials service agreements with capped fee structures, are accounted for using the percentage-of-completion method. We use the percentage-of-completion method of accounting because it is the most accurate method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; it is a better measure of periodic income results than other methods and it better matches revenue recognized with the costs incurred. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. The estimation of total hours and progress to completion on these arrangements determines the amount of revenue we recognize as well as whether a loss is recognized if one is expected to be incurred for the remainder of the project. Revisions to hour and cost estimates are incorporated in the period in which the facts that give rise to the revision become known.

We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support and/or maintenance ( PCS ). As a result, contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements. PCS may include rights to upgrades, when and if available, telephone support, updates and enhancements. When vendor specific objective evidence ( VSOE ) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. Accordingly, the judgments involved in assessing the fair values of various elements of an agreement can impact the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition, but would not change the total revenue recognized on the contract. When elements such as software and engineering services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. In the absence of fair value for a delivered element, revenue is first allocated to the fair value of the undelivered elements and then allocated to the residual delivered elements. In the absence of fair value for an undelivered element, the arrangement is accounted for as a single unit of accounting, resulting in a delay of revenue recognition for the delivered elements until the undelivered elements are fulfilled. As a result, contract interpretations and assessments of fair value are sometimes required to determine the appropriate accounting.

When engineering services and royalties are contained in a single arrangement, we recognize revenue from engineering services as earned in accordance with the criteria above even though the effective rate per hour may be lower than typical because the customer is contractually obligated to pay royalties on their device shipments. We recognize royalty revenue, classified as software revenue, when the royalty report from the customer is received or when such royalties are contractually guaranteed and the revenue recognition criteria are met, particularly that collectability is reasonably assured.

There are two items involving revenue recognition that require us to make our most difficult and subjective judgments: the determination of VSOE of fair value in multiple element arrangements and the estimation of percentage of completion on fixed-price service contracts. Historically, we have entered into very few multiple-element arrangements other than those involving the sale of PCS related to the sale of our TestQuest automated testing tools. We establish VSOE of fair value for TestQuest PCS using the bell-curve approach, based on the price when PCS is sold separately. VSOE of TestQuest PCS has been well established in the past as these products have been sold on a stand-alone basis for a number of years even prior to our acquisition of TestQuest assets in November 2008.

We primarily measure our estimate of completion on fixed-price contracts, which in turn determines the amount of revenue we recognize, based on actual hours incurred to date and our estimate of remaining hours necessary to complete the contract. The process of estimating the remaining hours on a contract involves detailed estimates of remaining hours by the engineers and project managers involved with the project, factoring in such variables as the remaining tasks, the complexity of the tasks, the contracted quality of the software to be provided, the customer's estimated delivery date, integration of third-party software and quality thereof and other factors. Every fixed-price contract requires various approvals within our Company including our Chief Executive Officer if significant. This approval process takes into consideration a number of factors including the complexity of engineering. We do not enter into fixed bid contracts where we do not have a history of performing any material portion of the contracted engineering tasks successfully. Historically our estimation processes related to fixed-price contracts have been accurate based on the information known at the time of the reporting of our results. However, percentage-of-completion estimates require significant judgment. As of March 31,



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## **Table of Contents**

2011, we were delivering engineering services under nine fixed-price service contracts. The percentage of completion calculations on these contracts represents management's best estimates based on the facts and circumstances as of the filing of this report. If there are changes to the underlying facts and circumstances, revisions to the percentage-of-completion calculations will be recorded in the period the changes are noted. If we were 20% under in our estimates of completion on every fixed-bid contract, our revenue would be over-stated by \$217,000 during the three months ended March 31, 2011.

### ***Allowance for Doubtful Accounts***

We review the accounts receivable regularly for collectability concerns. In determining the amount of our allowance for doubtful accounts, we make judgments about the creditworthiness of customers based on ongoing credit evaluations.

### ***Stock-Based Compensation***

Our stock-based compensation expense is estimated at the grant date based on the stock award's fair value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense over the requisite service period. The BSM model requires various highly judgmental assumptions including expected volatility and option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. Restricted Stock Units (RSUs) and Restricted Stock Awards (RSAs) are measured based on the fair market values of the underlying stock on the dates of grant. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience. To the extent our actual forfeiture rate is different from our estimate, stock-based compensation expense is adjusted accordingly.

### ***Incentive Compensation***

We make certain estimates, judgments and assumptions regarding the likelihood of attainment, and the level thereof, of bonuses payable under our annual incentive compensation programs. We accrue bonuses and recognize the resulting expense when the bonus is judged to be reasonably likely to be earned as of year-end and is estimable. The amount accrued, and expense recognized, is the estimated portion of the bonus earned on a year-to-date basis less any amounts previously accrued. These estimates, judgments and assumptions are made quarterly based on available information and take into consideration our year-to-date actual results and expected results for the remainder of the year. Because we consider estimated future results in assessing the likelihood of attainment, significant judgment is required. If actual results differ materially from our estimates, the amount of bonus expense recorded in a particular quarter could be significantly over or under estimated.

### ***Income Taxes***

As part of the process of preparing our Consolidated Financial Statements, we are required to estimate income taxes in each of the countries and other jurisdictions in which we operate. This process involves estimating our current tax expense together with assessing temporary differences resulting from the differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Net operating losses and tax credits, to the extent not already utilized to offset taxable income, also give rise to deferred tax assets. We must then assess the likelihood that any deferred tax assets will be realized from future taxable income, and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our deferred tax assets.

Beginning in 2002 and through the third quarter of 2010, we maintained a full valuation allowance against our deferred tax assets. In the fourth quarter of 2010, we determined that it was more likely than not that we would generate sufficient future taxable income to utilize a portion of our deferred tax assets, and realized the portion of our deferred tax assets that such taxable income would utilize.

Because we do business in foreign tax jurisdictions, our sales may be subject to other taxes, particularly withholding taxes. The tax regulations governing withholding taxes are complex, causing us to have to make assumptions about the appropriate tax treatment. Further, we make sales in many jurisdictions across the United States, where tax regulations are increasingly becoming more aggressive and complex. We must therefore continue to analyze our state tax exposure and determine what the appropriate tax treatments are, and make estimates for sales, franchise, income and other state taxes.

### **Results of Operations**

The following table presents certain financial data as a percentage of total revenue for the periods indicated. Our historical operating results are not necessarily indicative of the results for any future period.





**Table of Contents**

	<b>Three Months Ended March 31, 2011      2010 (unaudited)</b>	
<b>Revenue:</b>		
Software	72%	71%
Service	28	29
 Total revenue	 100	 100
<b>Cost of revenue:</b>		
Software	59	57
Service	21	36
 Total cost of revenue	 80	 93
<b>Gross profit</b>	<b>20</b>	<b>7</b>
<b>Operating expenses:</b>		
Selling, general and administrative	15	19
Research and development	3	5
 Total operating expenses	 18	 24
 Income (loss) from operations	 2	 (17)
Other income (expense)	0	(3)
 Income (loss) before income taxes	 2	 (20)
Income tax expense	(1)	(0)
 Net income (loss)	 1%	 (20)%

**Revenue**

Our revenue is generated from the sale of software, both our own proprietary software and software of third parties that we resell, and the sale of engineering services. Total revenue increased \$9.1 million, or 54%, to \$26.0 million during the three months ended March 31, 2011, from \$16.9 million in the year-ago period, due primarily to an increase in third-party software sales and, to a lesser extent, an increase in sales of engineering services.

Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and services delivered to foreign customers from our operations located in North America. Our international operations outside of North America consist principally of operations in Taiwan. We also have established relatively minor sales and/or support presences in China, India, Japan, Korea and the United Kingdom. Revenue from customers located outside of North America was \$6.7 million during the three months ended March 31, 2011, or 26% of total revenue, an increase from \$1.5 million, or 9% of total revenue, in the year-ago period. This international growth was primarily attributable to increased sales of the Microsoft Windows Mobile operating system in the Asia Pacific ( APAC ) region, and to a lesser extent, increased engineering service revenue in Asia and Europe.

**Software revenue**

Software revenue consists of sales of third-party software and revenue realized from our own proprietary software products, which include software license sales, royalties from our software products, sales of our software development kits, support and maintenance revenue, as well as royalties from certain engineering service contracts. Software revenue for the three months ended March 31, 2011 and 2010 was as follows (dollars in thousands):

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	Three months ended March 31, 2011                      2010 (unaudited)	
Software revenue:		
Third-party software	\$ 17,330	\$ 11,034
Proprietary software	1,419	978
 Total software revenue	 \$ 18,749	 \$ 12,012
 Software revenue as a percentage of total revenue	 72%	 71%
 Third-party software revenue as a percentage of total software revenue	 92%	 92%

**Table of Contents**

The vast majority of our third-party software revenue is comprised of sales of Microsoft Windows Embedded operating systems ( Windows Embedded OS ) in North America and sales of Microsoft Windows Mobile operating systems ( Windows Mobile OS ) on a worldwide basis. Third-party software revenue increased \$6.3 million, or 57%, to \$17.3 million for the three months ended March 31, 2011, from \$11.0 million in the year-ago period. Primarily this increase was due to a \$3.2 million increase in sales of Windows Mobile OS, primarily in the APAC region, and a \$2.9 million increase in sales of Windows Embedded OS. Higher sales of Windows Mobile OS were driven by a larger customer base compared to the prior year. Increased sales to our larger accounts, coupled with a change made by Microsoft which directs sales of certain Microsoft products through their embedded channel rather than other Microsoft channels, led to the increase in Windows Embedded OS sales.

Proprietary software revenue increased \$441,000, or 45%, to \$1.4 million for the three months ended March 31, 2011, from \$978,000 for the year-ago period. This increase was primarily due to increases in product support revenue for TestQuest and other products, coupled with our first sales of Qualcomm Snapdragon Mobile Development Platforms, and an increase in OMAP sales.

**Service revenue**

Service revenue for the three months ended March 31, 2011 and 2010 was as follows (dollars in thousands):

	<b>Three months ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Service revenue	\$ 7,259	\$ 4,933

Service revenue as a percentage of total revenue	28%	29%
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Service revenue increased \$2.3 million, or 47%, to \$7.3 million for the three months ended March 31, 2011, from \$4.9 million in the year-ago period. Service revenue increased primarily due to a new customer in North America which contributed \$1.3 million in service revenue during the three months ended March 31, 2011, compared to zero in the year-ago period, as well as other growth in North America and growth in Japan.

Ford Motor Company ( Ford ) continued to be our largest engineering services customer, representing 32% of service revenue during the three months ended March 31, 2011, compared to 47% of service revenue in the year-ago period. We began working with Ford in the second quarter of 2008 assisting in the development of their next generation in-dash infotainment offering called MyFord Touch. Our initial project with Ford began in the second quarter of 2008 and was completed in the third quarter of 2010. During the initial project we provided hardware design and implementation, platform level software development, application level software development, quality assurance services and systems integration services. The contract underlying the initial project began as a time and material contract, and in the second quarter of 2009 it was converted to a fixed-price contract. Since approximately the completion of the initial project, we have performed all services for Ford under a new time and materials contract which contains certain minimum commitments in terms of the number of resources we provide Ford, and amounts they pay us. This new time and materials contract, referred to as the Ford Telematics Competency Center ( FCC ), commits a certain number of engineering services personnel to Ford for a set fee subject to certain adjustments.

Ford contributed \$2.3 million in service revenue in both the three months ended March 31 2011 and 2010. Ford revenue was negatively impacted in the year-ago period by overruns we incurred on the original program which, in turn, impacted the amount of revenue we recognized. A portion of the overruns was subsequently recouped during the three months ended June 30, 2010 when an amendment to the original agreement was signed which provided, among other things that Ford reimburse us for a portion of the overruns we incurred. As such, we recognized \$2.5 million of service revenue during the three months ended June 30, 2010 would have been recognized in the year-ago period had the amendment been signed earlier. The number of engineers working on Ford has declined under the FCC as compared to the number of engineers working on the original project in the prior year as we are no longer in the development stage of the MyFord Touch platform, but are now focused on developing and integrating new user applications for the MyFord Touch, enhancing existing applications and customizing the MyFord Touch platform for additional vehicle models. In February 2011, a new amendment was signed with Ford that expanded the size of the FCC team and extended the term of the agreement to December 31, 2011. Under this new agreement, we expect the FCC to generate \$9.3 million in revenue in 2011 subject to certain adjustments.

**Table of Contents****Gross profit and gross margin**

Cost of revenue related to software revenue consists primarily of the cost of third-party software as well as the amortization of certain intangible assets related to acquisitions.

Cost of revenue related to service revenue consists primarily of salaries and benefits, contractor costs and re-billable expenses, plus related facilities and depreciation costs. Gross profit on the sale of third-party software products is also positively affected by rebate credits we received from Microsoft of \$206,000 during the three months ended March 31, 2011 and \$186,000 during the three months ended March 31, 2010, respectively, which we earn through the achievement of defined objectives and are treated as a reduction in the cost of software revenue.

The following table outlines software, services and total gross profit (dollars in thousands):

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(unaudited)</b>	
Software gross profit	\$ 3,480	\$ 2,367
Software gross margin	19%	20%
Service gross profit	\$ 1,770	\$ (1,185)
Service gross margin	24%	-24%
Total gross profit	\$ 5,250	\$ 1,182
Total gross margin	20%	7%

**Software gross profit and gross margin**

Software gross profit increased by \$1.1 million, or 47%, to \$3.5 million for the three months ended March 31, 2011, from \$2.4 million in the year-ago period, while software gross margin declined one percentage point. The increase in software gross profit and the decline in gross margin were driven primarily by an increase in sales of lower margin third-party software products, primarily Windows Embedded OS and Windows Mobile OS. Third-party software margin was 13% and our proprietary software margin was 82% during the three months ended March 31, 2011. These margins were relatively consistent compared to the year-ago period in which third-party software margin was 14% and proprietary software margin was 85%.

**Service gross profit and gross margin**

Service gross profit increased \$3.0 million, or 249%, to \$1.8 million for the three months ended March 31, 2011, from negative gross profit of (\$1.2) million in the year-ago period. Our service gross margin was 24% for the three months ended March 31, 2011, a 48 percentage point increase from (24%) the year-ago period. The increase in service gross profit and gross margin was primarily due to overruns on the Ford project in the year-ago period. As of the time of the filing of our Quarterly Report on Form 10-Q for the three months ended March 31, 2010, no additional funds had been committed to by Ford to cover the overruns on the project and a \$390,000 loss contract accrual was recognized, negatively affecting our gross profit by that amount and gross margin by 11 percentage points.

**Operating expenses***Selling, general and administrative*

Selling, general and administrative expenses consist primarily of salaries and related benefits, commissions and bonuses for our sales, marketing and administrative personnel and related facilities and depreciation costs, as well as professional services fees (e.g., consulting, legal and audit). Selling, general and administrative expenses increased \$795,000, or 25%, to \$3.9 million for the three months ended March 31, 2011, from \$3.1 million in the year-ago period. Selling, general and administrative expenses represented 15% of our total revenue for the three months ended March 31, 2011 and 19% in the year-ago period. The increase was primarily due to incremental costs related to growing our sales teams both domestically and internationally, international expansion costs such as tax planning services, higher marketing expenses, higher fringe benefits expense, increased stock compensation expense and lower allocation of headcount-based facilities expense to service cost of sales and research and development.

*Research and development*

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Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs, component costs and related facilities and depreciation costs. Research and development expenses increased \$7,000, or 1%, to \$914,000 for the three months ended March 31, 2011, from \$907,000 in the year-ago period.

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## **Table of Contents**

Research and development expenses represented 3% of our total revenue for the three months ended March 31, 2011 and 5% in the year-ago period.

### ***Other income or expense***

Other income or expense consists of interest income on our cash, cash equivalents and investments, gains and/or losses we may recognize on our investments, as well as gains or losses on foreign exchange transactions. Other income increased \$496,000, or 102%, to \$8,000 for the three months ended March 31, 2011, from an expense of \$488,000 in the year-ago period. This increase was primarily due to a \$510,000 other-than-temporary impairment loss we recognized in the year-ago period on our ARS investments. During the three months ended March 31, 2010, we decided to liquidate our portfolio of ARS at market rates, which were expected to be lower than their carrying values and, accordingly, we recognized an other-than-temporary valuation allowance which was recorded as a charge to other expense in the year-ago period.

### ***Income tax expense***

Income tax expense increased \$138,000 to \$229,000 for the three months ended March 31, 2011, as compared to \$91,000 in the year-ago period. This increase was primarily due to U.S. federal and state income taxes recognized as a result of our taxable income during the three months ended March 31, 2011. In prior periods we had fully reserved our deferred tax assets, and did not recognize U.S. federal and state income taxes other than alternative minimum tax.

Our U.S. effective income tax rate is 36% of pre-tax net income which includes both state and federal income taxes. The remainder of the tax expense we recognized during the three months ended March 31, 2011 relates to international income taxes, U.S. alternative minimum tax because of our net operating loss carryforwards and expense due to higher than anticipated amounts owed to the state of California for 2010 income taxes.

### **Liquidity and Capital Resources**

As of March 31, 2011, we had \$21.4 million of cash, cash equivalents, short-term and a long-term investment and restricted cash, compared to \$23.1 million at December 31, 2010. Of this amount \$8.3 million and \$10.8 million was cash at March 31, 2011 and December 31, 2010, respectively, and \$997,000 was long-term at both March 31, 2011 and December 31, 2010. These balances are net of a valuation allowance of \$378,000 recorded against our ARS at March 31, 2011 and December 31, 2010. Our restricted cash balance of \$875,000 at both March 31, 2011 and December 31, 2010 relates to the securitization of a letter of credit for our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital was \$20.9 million at March 31, 2011 compared to \$20.0 million at December 31, 2010.

Net cash used by operating activities was \$1.6 million for the three months ended March 31, 2011, driven by a \$1.7 million increase in accounts receivable, a \$611,000 reduction in accounts payable and other accrued liabilities, offset in part by \$714,000 in non-cash charges. The increase in accounts receivable was due to a higher balance with Ford as compared to December 31, 2010. Net cash used by operating activities was \$2.0 million for the three months ended March 31, 2010, primarily attributable to a \$3.1 million net loss, offset by \$907,000 in non-cash charges, mainly a \$510,000 other-than-temporary impairment on our ARS.

Investing activities used cash of \$897,000 for the three months ended March 31, 2011, primarily due to investment purchases of \$6.4 million, offset by \$5.6 million of proceeds from maturities of marketable securities. Investing activities provided cash of \$12,000 for the three months ended March 31, 2010.

Financing activities generated \$66,000 in cash during the three months ended March 31, 2011, and \$8,000 during the three months ended March 31, 2010, as a result of employees' exercise of stock options.

We believe that our existing cash, cash equivalents and investments will be sufficient to meet our needs for working capital and capital expenditures for at least the next 12 months.

### **Cash Commitments**

We have the following future or potential cash commitments:

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Minimum rents payable under operating leases total \$995,000 for the remainder of 2011, \$1.2 million in 2012, \$1.1 million in 2013, and \$770,000 in 2014; and

Under the terms of our corporate headquarters lease signed in February 2004, the landlord has the ability to demand payment for cash payments forgiven in 2004 if we default under the lease. The amount of the forgiven payments for which the landlord can demand repayment was \$819,000 at March 31, 2011, and decreases on a straight-line basis over the remaining term of the lease, which expires in 2014.



## **Table of Contents**

### **Recently Issued Accounting Standards**

See Note 1, Summary of Significant Accounting Policies in the Notes to Condensed Consolidated Financial Statements in Item 1.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

### **Item 4. Controls and Procedures**

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that the information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Our management carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2011 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**

There has been no material change in the risk factors set forth in Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010.

### **Item 6. Exhibits**

The exhibits listed in the accompanying Index to Exhibits are filed or incorporated by reference as part of this Quarterly Report on Form 10-Q.

**Table of Contents**

**SIGNATURES**

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

**BSQUARE CORPORATION**  
(Registrant)

Date: May 5, 2011

By: */s/* **BRIAN T. CROWLEY**  
**Brian T. Crowley**

**President and Chief Executive Officer**

Date: May 5, 2011

By: */s/* **SCOTT C. MAHAN**  
**Scott C. Mahan**

**Vice President, Finance and Chief Financial Officer**

**Table of Contents****BSQUARE CORPORATION****INDEX TO EXHIBITS**

<b>Exhibit</b>		<b>Incorporated by Reference</b>				
<b>Number</b>	<b>Description</b>	<b>Filed Herewith</b>	<b>Form</b>	<b>Filing Date</b>	<b>Exhibit</b>	<b>File No.</b>
3.1	Amended and Restated Articles of Incorporation		S-1	8/17/1999	3.1(a)	333-85351
3.1(a)	Articles of Amendment to Amended and Restated Articles of Incorporation		10-Q	8/7/2000	3.1	000-27687
3.1(b)	Articles of Amendment to Amended and Restated Articles of Incorporation		8-K	10/11/2005	3.1	000-27687
3.2	Bylaws and all amendments thereto		10-K	3/19/2003	3.2	000-27687
10.18(e)+	Amendment #3 to Statement of Work #3, entered into on February 6, 2011 and effective as of January 1, 2011, under the Hardware Design and Systems Integration Services Global Terms and Conditions, and statements of work thereunder, between Ford Motor Company and BSQUARE Corporation, entered into on and effective as of December 30, 2009		10-K	3/17/2011	10.18(e)	000-27687
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934	X				
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934	X				
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X				
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X				

+ Confidential treatment has been requested with respect to the redacted portions of the referenced exhibit.