

BSQUARE CORP /WA
Form 10-K
February 25, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2013

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)

Washington
(State or other jurisdiction of
incorporation or organization)

91-1650880
(I.R.S. Employer

Identification Number)

110 110th Avenue NE, Suite 200, Bellevue, Washington 98004

(Address of principal executive offices, including zip code)

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Registrant's telephone number, including area code: (425) 519-5900

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|----------------------------|---|
| Common Stock, no par value | The NASDAQ Stock Market LLC (NASDAQ Global Select Market) |

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

The aggregate market value of common stock held by non-affiliates of the registrant as of June 30, 2013 was approximately \$30,700,000 based on the closing price of \$2.75 per share of the registrant's common stock as listed on the NASDAQ Global Select Market.

The number of shares of common stock outstanding as of January 31, 2014: 11,394,010

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be delivered to shareholders in connection with the 2014 annual meeting of shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

Item 1. Business.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K, including any information incorporated by reference, contains 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, you 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 terms, which when 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 set forth under Item 1A, Risk Factors. Such forward-looking statements include, but are not limited to, statements with respect to the following:

the development of the smart, connected systems market and our ability to address its opportunities and challenges;

the adoption of the various Microsoft® Windows Embedded and Windows Mobile operating systems as well as Android, Linux, QNX and other operating systems that our software offerings support as the systems of choice for many device hardware and software vendors;

our business plan and our strategy for implementing our plan;

our ability to expand and capitalize on our strategic relationships with silicon vendors and other hardware and software vendors;

our ability to maintain our relationship with Microsoft Corporation (Microsoft) and expectations related to our distribution of Windows Mobile and other Microsoft Windows Embedded operating systems;

our ability to address challenges and opportunities in the international marketplace;

our ability to develop our technology and expand our proprietary software and service offerings; and

our anticipated working capital needs and capital expenditure requirements, including our ability to meet our anticipated cash needs. Readers are cautioned not to place undue reliance on 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. Readers, however, should carefully review the factors set forth in this and other reports or documents that we file from time to time with the Securities and Exchange Commission (SEC).

BUSINESS

Overview

As used in this Annual Report on Form 10-K, we, us, our and the Company refer to BSQUARE Corporation. We provide software solutions and related engineering services to companies that develop smart, connected systems. A smart, connected system is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® CE or Google Android) and is usually connected to a network or data cloud via a wired or wireless connection. Examples of smart, connected systems include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, tablets,

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handheld data collection devices, personal media players, smart phones, vending machines and in-vehicle telematics and entertainment devices. We focus on smart, connected systems that utilize various Microsoft Windows Embedded and Windows Mobile operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX.

We have been providing software solutions for smart, connected systems since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs) and corporate enterprises (Enterprises), as well as silicon vendors (SVs) and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales. In the case of Enterprises, our customers include those which develop, market and distribute smart, connected systems on their own behalf as well as those that purchase systems from OEMs or ODMs and require additional software, integration and/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.

We were incorporated in the State of Washington in July 1994. Our principal office is located at 110 110th Avenue NE, Suite 200, Bellevue, Washington 98004, and our telephone number is (425) 519-5900.

Industry Background

The increasing opportunity for connectivity and exchange of data coupled with the rise of cloud storage and cloud computing infrastructure is driving new applications for smart, connected systems of all kinds.

The smart, connected systems industry is characterized by a wide variety of software and hardware configurations and end-user applications, often designed to address a specific vertical market. To accommodate these diverse characteristics in a cost-effective manner, OEMs, ODMs and Enterprises require operating systems and software that can support a diverse set of hardware requirements and connect to a wide variety of networks, systems, peripherals, content and applications.

The smart, connected systems marketplace is being influenced by the following factors:

Continuing demand by business professionals and consumers for integrated mobile devices, which combine telephony, data (such as email and internet browsing), multimedia, location awareness and cameras;

Businesses are looking to deploy specialized devices into stores, shopping centers, shop floors, etc., or to their employees who work in the field but need connectivity to business systems and data;

The ubiquity of cellular and WLAN wireless networks is driving rapid adoption of smart connected systems that leverage broadband and high-speed wireless data networks, including Internet Protocol (IP) set-top boxes, voice-over-IP (VoIP) phones, residential gateways, and home networking solutions linking smart connected systems with PCs;

Expectations for device functionality continue to grow. Users expect to be able to access email and the Internet, synchronize their devices with cloud and corporate data sources and deploy multiple applications on their devices;

The availability of multimedia content has increased demand for high-performance, multimedia-capable devices that are able to access, share and play audio, video and application content located on remote computers;

Security is an increasingly important concern as devices are now often able to access networks and store sensitive information locally such as email, spreadsheets and other documents. Users are demanding that these types of information be protected in the same ways they are protected on the desktop;

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Higher bandwidth networks coupled with larger displays and increased processing power found on new devices means that more multimedia content will be available to devices increasing demand for digital rights management, content management and related technologies;

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Increase in device complexity is being driven by rising user expectations of functionality, complex device interactions with wireless networks and updated versions of embedded operating systems and silicon processors, all of which are driving OEMs, ODMs and Enterprises to continually refresh and update their device designs; and

The vastly increasing number of sensors and similar devices requires new solutions for these devices to interact with other devices autonomously through the Internet of Things and to provide data to applications, both those that reside local to the device and those running in the cloud.

Software Solutions for Smart Connected Systems

Our customers include world class OEMs and ODMs, Enterprises, SVs and peripheral vendors which are developing smart connected systems or assisting others in doing so. Representative customer engagements in 2013 included the following:

We continued in the development of a next generation infotainment offering called MyFord Touch which is a product of Ford Motor Company (Ford). The MyFord Touch infotainment system is an in-car communications and entertainment system which enables drivers of Ford's car offerings to access a wide range of connected information and entertainment experiences including music and multi-media services, hands-free telephony, Internet-enabled applications, language services, news and navigation;

Bsquare has been a supplier to Outerwall (formerly Coinstar) since 2005 for their Windows Embedded Operating Systems that are deployed on their Coin Kiosks. During the last 7-8 years Bsquare has provided Coinstar with engineering services for their New Venture Kiosks in addition to the Coin Kiosk. In 2013 we provided licensing consultation and engineering services for the Redbox division of Outerwall.

The Coca-Cola Company (Coca-Cola) continues to engage in development of Freestyle[®]Coke's next generation drink dispensing machine.

We worked with Costa Coffee to bring the new generation of beverage vending devices to market with technologies including outbound cameras and demographic mapping. This included providing connectivity through the cloud to back-end applications. The software we deliver to our customers as part of our smart connected software solutions takes three forms. The first is our own proprietary software products, the second is best-of-class third-party software products and the last is custom software delivered through our engineering services teams. Due to the complexity of embedded software, the integration of our own proprietary software, third-party software products and customer software on customers' devices often requires us to provide additional engineering services addressing systems integration, customization and/or optimization as well as quality assurance testing. Our goal is to increase the breadth and depth of our software product and engineering service offerings to our customers to enhance our position as an overall smart connected software solutions provider.

Proprietary Software Products

Our primary proprietary software offerings being actively sold or developed include:

HTML5 Rendering Engine Our award-winning HTML5 Rendering engine is based on the open-source WebKit platform which is maintained by a number of leading internet and device companies. Using WebKit, device makers can create portable applications and user interfaces for their devices using the industry-standard HTML5 markup language. We ported WebKit to the latest versions of Microsoft's Windows Embedded Compact Operating System and sell our porting layer to customers along with engineering services to implement our WebKit port on their devices;

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TestQuest 10 TestQuest 10 is our latest generation software testing automation tool that provides customers with a complete test solution that brings together everything necessary to test smart connected systems including tools to create and manage test cases, a platform that allows teams to

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collaborate on test development, an execution environment that enables tests to be executed on the smart connected systems and capture results, and a reporting tool that allows customers to analyze test results;

Third-Party Software Products

We have distribution agreements with multiple third-party software vendors. Our ability to resell these third-party software products, whether stand-alone or in conjunction with our own proprietary software and engineering service offerings, provides our customers with a significant solution source for their project needs. Our primary third-party software offerings include the following:

For 15 years, we have been a Microsoft authorized Value-Added Provider (VAP) of Windows Embedded operating systems and toolkits for Windows Embedded Compact, Windows Embedded Standard and Windows Embedded Server, along with other Microsoft related and legacy technology. We are authorized to sell Windows Embedded operating systems in North America, including Mexico, as well as much of the European Union. Of our total revenue in 2013, 58% was generated through the sale of Windows Embedded operating systems, compared to 48% in 2012. Our current distribution agreements related to Windows Embedded expire in June 2014;

We have been a Microsoft authorized VAP of Windows Mobile operating systems since November 2009. Along with Windows Mobile operating systems, we also sell Microsoft s Office Mobile and several other related products. We are currently authorized to sell Windows Mobile operating systems and related products in North America, South America, and Central America (the Americas), Japan, Taiwan, and the region comprised of Europe, the Middle East, and Africa (EMEA). Of our total revenue in 2013, 11% was generated through the sale of Windows Mobile operating systems, compared to 18% in 2012. Our current distribution agreements related to Windows Mobile expire in June 2014. Previously, we also had rights to distribute Windows Mobile operating systems in Korea which ended on October 31, 2012. We sold \$4.5 million of Windows Mobile operating systems in Korea in 2012;

We are an authorized distributor for Adobe Flash Lite technology. We have the right to distribute Adobe Flash Lite licenses on a worldwide basis;

We are an authorized distributor of McAfee Inc. s Embedded Security product in North America; and

We sub-license and resell other third-party software such as Datalight Inc. s FlashFX and Reliance products. Software revenue for the last two fiscal years was as follows (in thousands):

| | 2013 | 2012 |
|--|-----------|-----------|
| Software revenue: | | |
| Third-party software | \$ 70,891 | \$ 71,130 |
| Proprietary software | 2,513 | 4,710 |
| Total software revenue | \$ 73,404 | \$ 75,840 |
| Software revenue as a percentage of total revenue | 80% | 75% |
| Third-party software revenue as a percentage of total software revenue | 97% | 94% |

The sale of Microsoft operating systems has accounted for substantially all of our third-party software revenue historically, including 90% of third-party software revenue in 2013 and 94% of third-party software revenue in 2012.

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Engineering Service Offerings

We offer a variety of engineering services to our customers including:

Architectural and system design;

Software design and development;

Platform development systems integration;

Radio Interface Layer (RIL) development and testing;

Application, middleware and multimedia software development;

Adobe Flash Lite Player porting and Flash User Interface development;

Quality assurance and testing;

Device solution strategy consulting;

Technical support;

Implementation; and

Training.

Customers utilize our engineering services due to our extensive device software development and testing experience and because of our deep experience with embedded and mobile operating systems. We believe that engaging us on a new device design typically results in shorter development cycles and reduced time-to-market, lower overall costs to complete projects, and enhanced product robustness and features, which a customer may have been unable to achieve through other means.

Service revenue for the last two fiscal years was as follows (in thousands):

| | 2013 | 2012 |
|--|-------------|-------------|
| Total service revenue | \$ 18,704 | \$ 25,554 |
| Service revenue as a percentage of total revenue | 20% | 25% |

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Service revenue related to the MyFord Touch program was \$4.5 million, or 24% of service revenue, in 2013 and \$6.4 million, or 25% of service revenue, in 2012.

Strategy

Our strategy is to continue to enhance our position as a leading provider of software solutions and related services for smart connected systems, ultimately becoming the go-to solutions provider for our customers and potential customers around the globe. To advance this strategy, we intend to focus on the following:

Expanding the breadth of services we offer to our customers, particularly those that are focused on making existing smart connected systems more useful and valuable to their customers;

Expanding our geographic sales penetration in those areas where we have not achieved significant market share;

Building our offerings and capabilities in the rapidly growing Internet of Things market. As we drive to grow in this market, we will seek to deepen our relationships with our world-class Fortune 500 customers and to deliver a family of products and services that will turn raw device data into useful, meaningful and actionable information; and

Seeking additional proprietary software products in which to invest.

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Relationship with Microsoft and Impact on our Smart Connected Solutions Business

We have a long-standing relationship with Microsoft and this relationship is critical to the continuing success of our business. Our credentials as a Microsoft partner include:

We have been one of Microsoft's largest distributors of Windows Embedded operating systems (e.g. Windows Embedded Compact and Windows Embedded Standard) for over 15 years;

We have been a distributor of Microsoft's Windows Mobile operating systems since November 2009;

We are a Windows Embedded Gold-level Systems Integrator;

We are a Microsoft Gold Certified Partner;

We were the OED Americas Channel Sales & Marketing Award recipient for Distributor Sales Excellence in 2013;

We were the Microsoft Distributor of the Year for 2011;

We received a Microsoft Technical Excellence Award for our delivery of highest quality technical solutions on the latest Windows Embedded technologies in the European region in 2011;

Our HTML5 Rendering Engine won a Microsoft Technical Excellence Award in 2012;

We are a developer and provider of Microsoft Official Curriculum Training for Windows Embedded Compact and Windows Embedded Standard;

We are a Preferred Provider of Visual Tools for Microsoft;

We are a Gold-level member of Microsoft's Third-Party Tools Provider Program; and

We have been engaged by Microsoft on various service engagements.

We work closely with Microsoft executives, developers, product managers and sales personnel. We leverage these relationships in a variety of ways, including:

We gain early access to new Microsoft embedded software and other technologies;

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We are able to leverage co-marketing resources, content and strategies from Microsoft, including market development funds, to support our own marketing and sales efforts;

We participate in Microsoft-sponsored trade shows, seminars, and other events;

We receive sales leads from Microsoft; and

We receive rebates from Microsoft based upon the achievement of predefined sales objectives.

See Item 1A, Risk Factors, for more information regarding our relationship with Microsoft.

Customers

Customers of our software solutions and engineering services include leading OEMs, ODMs, Enterprises, SVs and peripheral vendors seeking to leverage the software we provide them, be it our own proprietary software, third-party software or custom software developed via our engineering services, to develop high-quality, smart connected systems that meet the requirements of numerous end-markets. Representative customers include Microsoft, Coca-Cola, Costa Coffee, IGT, Mitsubishi Electric Corporation, Honeywell International, Inc., Elo Touch Solutions, Intel, and several industrial handset companies.

Sales and Marketing

We market our software solutions and engineering services utilizing a direct sales model. We have sales personnel throughout the United States and in various countries in Asia and Europe. Historically, we have not made significant use of resellers, channel partners, representative agents or other indirect channels.

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Key elements of our sales and marketing strategy include direct marketing, content marketing, trade shows, event marketing, public relations, analyst relations, social media properties, customer and strategic alliance partner co-marketing programs and a comprehensive website. We rely significantly on lead referral and other marketing support programs from strategic partners.

Research and Development

Our research and development personnel are responsible for the design, development and release of our proprietary software products. Members of our research and development staff work closely with our sales and marketing departments, as well as with our customers and potential customers, to better understand market needs and requirements. We perform our research and development primarily utilizing engineering staff located in the United States. Research and development expense was \$2.8 million and \$3.6 million in 2013 and 2012, respectively.

Competition

The market for smart connected systems software and services is extremely competitive. We face competition from the following:

Our current and potential customers' internal research and development departments, which may seek to develop their own software solutions which compete with our proprietary software products and engineering services;

Engineering service firms, including off-shore development companies, such as Adeneo, SymphonyTeleca and Wipro;

ODMs, particularly those in Taiwan and China, which have added or are adding software development capabilities to their offerings;

Contract manufacturers which have added or are adding software development capabilities to their offerings;

Mobile and embedded test automation providers including Perfecto Mobile, mVerify, JAMO Solutions, SmartBear Software (AutomatedQA), TestPlant (eggPlant) and Keynote. In this market we also compete against customers' internally created tools and against manual testing;

Microsoft Windows Embedded and Windows Mobile operating system distributors such as Arrow Electronics, Inc. Avnet, Inc. and Synnex Corporation in Taiwan;

Marketing agencies and specialized vendors who provide mobile application services; and

We will encounter increasing competition in the growing Internet of Things market from a number of additional software and service providers as we expand our focus on this market in 2014 and beyond.

Some of our competitors focus on only one aspect of our business or offer complementary products which can be integrated with our products. As we develop and bring to market new software products and service offerings, we may begin competing with companies with which we have not previously competed. Further, as we expand the geographic markets into which we sell our software solutions and related services, or increase our penetration therein, we may expect to increasingly compete with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share. Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced software and service revenue opportunities for us. The barrier to entering the market as a provider of Microsoft-based smart connected systems software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded and Windows Mobile operating system software and services. These systems integrators are

given substantially the

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same access by Microsoft to the Microsoft technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the connected device market, and as new products and technologies are introduced.

International Operations

Our international operations outside of North America consist principally of operations in Beijing, China, Taipei, Taiwan and Trowbridge, England. We have minor sales and sales support presences in other countries in Asia and Europe as well. We closed our Beijing, China operations in October 2013. Because our OEM Distribution Agreement with Microsoft for the sale of Microsoft Windows Embedded operating systems (e.g. Windows Embedded Compact) has been, until relatively recently, restricted to North America, including Mexico, the majority of our revenue continues to be generated from North America. In 2013, revenue generated from customers located outside of North America was 13% of total revenue, compared to 20% in 2012. The decrease in non-North American revenue in 2013 was primarily attributable to lower sales of Windows Mobile operating systems, lower service revenue and lower proprietary software sales in Asia. Specifically, a portion of the Windows Mobile operating systems sales decline resulted from the expiration of our Korea distribution rights on October 31, 2012, as prior sales in Korea contributed \$4.5 million of Windows Mobile operating systems revenue in 2012.

See Item 1A, Risk Factors, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, for more information regarding our international operations.

Personnel

The following indicates the total number of employees by area:

| | December 31, | |
|-------------------------------------|---------------------|-------------|
| | 2013 | 2012 |
| Engineering Services | 119 | 149 |
| Research and Product Development | 12 | 22 |
| Sales, Marketing and Administrative | 56 | 70 |
| Total | 187 | 241 |

As of December 31, 2013, we were also utilizing the services of 18 contractors, primarily for engineering services, compared to 19 at December 31, 2012. Of the total headcount of 205 at December 31, 2013, 121 were located in North America, 50 were located in Taiwan, 32 were located in the United Kingdom and 2 were located in Japan. As conditions necessitate, engineering service employees perform research and development activities and vice versa. In October 2013, we effected a headcount reduction that impacted approximately 20% of our worldwide workforce.

Intellectual Property and Other Proprietary Rights

In general, we attempt to protect our intellectual property rights through patent, copyright, trademark and trade secret laws and through contractual arrangements. However, we cannot be certain that our efforts will be effective to prevent the misappropriation of our intellectual property, or to prevent the development and design by others of products or technologies similar to, or competitive with, those developed by us.

Additionally, because a significant portion of our revenue relates to the sale of third-party software products, we also rely on our partners, particularly Microsoft, to appropriately protect their own intellectual property.

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We have eight issued United States (US) patents, one US patent application and one pending international application. We also have a number of registered trademarks in various jurisdictions. We will continue to pursue appropriate protections for our intellectual property.

See Item 1A, Risk Factors, for more information regarding our intellectual property and other proprietary rights.

Available Information

We are a reporting company and file annual, quarterly and current reports and other information with the SEC. You may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, NE, Washington, DC 20549. You also may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information we file electronically with the SEC at <http://www.sec.gov>.

Our Internet website is located at www.bsquare.com. We make available, free of charge, through the investor relations section of our website, under SEC Filings, all our filings, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after such material is filed with, or furnished to, the SEC.

Directors and Executive Officers of the Registrant

The following table sets forth certain information with respect to our directors and executive officers as of January 31, 2014:

| Name | Age | Position |
|--------------------------|------------|---|
| Andrew Harries | 51 | Chairman of the Board |
| Jerry Chase | 54 | President and Chief Executive Officer; Director |
| Elliott H. Jurgensen, Jr | 69 | Director |
| Harel Kodesh | 55 | Director |
| William D. Savoy | 49 | Director |
| Kendra A. VanderMeulen | 62 | Director |
| Mark Whiteside | 51 | Senior Vice President, Professional Services; Interim Senior Vice President of US Solutions and International Sales |
| Scott C. Mahan | 49 | Senior Vice President, Operations; Chief Financial Officer; Secretary and Treasurer |

Item 1A. Risk Factors.

As discussed under Item 1 of Part I, Business Forward-Looking Statements, our actual results could differ materially from those expressed in our forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed below. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. If any of the following risks occur, our business, financial condition, operating results, cash flows and the trading price of our common stock could be materially adversely affected.

Microsoft-Related Risk Factors

Due to the fact that we provide software and services to customers building devices utilizing Microsoft’s Windows Embedded and Windows Mobile operating systems, as well as the fact that a significant portion of our revenue is derived from the sale of Microsoft Windows Embedded and Windows Mobile operating systems, Microsoft has a significant direct and indirect influence on our business. The following Microsoft-related risk factors may negatively impact our business and operating results.

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If we do not maintain our OEM Distribution Agreements with Microsoft or if Microsoft de-emphasizes or divests itself from these areas of its business, our revenue would decrease and our business would be adversely affected.

We have OEM Distribution Agreements (ODA s) for Software Products for Embedded Systems with Microsoft, which enable us to sell various Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba), Mexico, the European Union and the European Free Trade Association. These ODAs are effective through June 30, 2014. We have also entered into other ODAs with Microsoft pursuant to which we are licensed to sell Microsoft Windows Mobile operating systems to customers in North America, South America, Central America, Japan, Taiwan, Europe, the Middle East, and Africa. The ODAs to sell Windows Mobile operating systems are effective through June 30, 2014.

We generated \$64.0 million and \$67.0 million of revenue in 2013 and 2012, respectively, through our sales of Microsoft operating systems and expect this revenue stream to continue in 2014. Our rights to distribute Windows Mobile operating systems in Korea expired on October 31, 2012. We sold \$4.5 million of Windows Mobile operating systems in Korea in 2012. If any of the ODAs are terminated by Microsoft (which Microsoft can do unilaterally) or not renewed, or if Microsoft decides to no longer invest in or to divest itself from these areas of its business, our software revenue and resulting gross profit could decrease significantly and our operating results would be negatively impacted. Future renewals, if any, could be on less favorable terms, which could also negatively impact our business and operating results.

Microsoft can change pricing under the ODAs at any time and unless we are able to either pass through price increases to our customers or sign our customers to 12-month purchasing commitments, which lowers the price we pay to Microsoft, our revenue, gross profit and operating results would be negatively impacted. Further, Microsoft currently offers a rebate program in conjunction with our ODA activities in which we earn money for achieving certain predefined objectives. If Microsoft were to eliminate or negatively modify the rebate program, our gross profit and operating results would be negatively impacted. We earned rebate credits from Microsoft of \$1.2 million and \$888,000 in 2013 and 2012, respectively, a portion of which is accounted for as a reduction in cost of sales and a portion as a reduction in marketing expense if and when qualified expenditures are made.

Microsoft has audited our records under the ODAs in the past and will likely audit our records again in the future and any negative audit results could result in additional charges and/or the termination of the ODAs.

There are provisions in the ODAs that require us to maintain certain internal records and processes for auditing and other reasons. Non-compliance with these and other requirements could result in the termination of the ODAs. Microsoft has concluded audits of our records pertaining to the ODAs in 2009 and 2006, neither of which had material findings. It is possible that future audits could result in charges due to any material findings that are found.

If we are invoiced by Microsoft for a pricing adjustments under OVRP arrangements and we are unable to pass through the charge to our customers, our operating results and cash flow would be negatively impacted.

In conjunction with our activities under the ODAs with Microsoft, we enter into OEM Volume Royalty Program (OVRP) commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don t meet the committed minimum unit volumes, we are obligated to pay the difference between the committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. While our history with OVRP arrangements has shown that very few result in a price adjustment and, for

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those that have, we have been able to pass through the price adjustment to our customer, in the event the customer is unwilling or unable to pay us, our operating results and cash flow would be negatively impacted.

If we do not maintain our favorable relationship with Microsoft, we will have difficulty marketing and selling our software and services and may not receive developer releases of Microsoft Windows Embedded and Windows Mobile operating systems. As a result, our revenue and operating results could suffer.

We maintain a strategic marketing relationship with Microsoft. If our relationship with Microsoft deteriorates for any reason, including an increased focus by us on customers building devices utilizing non-Microsoft operating systems, our efforts to market and sell our software and services to our customers could be adversely affected and our business could be harmed. Microsoft has significant influence over the development plans and buying decisions of customers utilizing the various Microsoft Windows Embedded and Windows Mobile operating systems. Microsoft provides customer referrals to us. Moreover, Microsoft controls the marketing campaigns related to its operating systems. Microsoft's marketing activities, including trade shows, direct mail campaigns and print advertising, are important to the continued promotion and market acceptance of Microsoft Windows Embedded and Windows Mobile operating systems and, consequently, to our sale of Windows-based software and services. We must maintain a favorable relationship with Microsoft to continue to participate in joint marketing activities with them, which includes participating in partner pavilions at trade shows, listing our services on Microsoft's website, and receiving customer referrals. In the event that we are unable to continue our joint marketing efforts with Microsoft, or fail to receive referrals from them, we would be required to devote significant additional resources and incur additional expenses to market our software products and services directly to potential customers. In addition, we depend on Microsoft for developer releases of new versions of, and upgrades to, its Windows Embedded and Windows Mobile software in order to facilitate timely development and delivery of our own software and services. If we are unable to maintain our favorable relationship with Microsoft and no longer continue receiving such new versions and updates, our revenue could decline significantly, and/or our costs could increase significantly, thereby negatively impacting our operating results.

Unexpected delays or announcement of delays by Microsoft related to product releases of Windows Embedded or Windows Mobile operating systems could adversely affect our revenue and operating results.

Unexpected delays or announcement of delays in Microsoft's delivery schedule for new versions of Windows Embedded or Windows Mobile operating systems could cause us to delay our product introductions or impede our ability to sell our products and services and/or to complete customer projects on a timely basis. Such delays or announcements of delays by Microsoft could also cause our customers to delay or cancel their project development activities or product introductions, which could negatively impact our revenue and operating results.

If Microsoft adds features to its Windows operating systems or develops products that directly compete with products and services we provide, our revenue and operating results could be negatively impacted.

As the developer of Windows Embedded and Windows Mobile operating systems, Microsoft could add features which eliminate or reduce our customers' need for our software and services, or Microsoft could develop standalone products and services that compete with the products and services we provide to our customers. The ability of our customers, or potential customers, to obtain products and services directly from Microsoft that compete with our products and services could negatively impact our revenue and operating results. Even if the standard features of future Microsoft operating system software were more limited than our offerings, a significant number of our customers, and potential customers, might elect to accept more limited functionality in lieu of purchasing additional software from us or delay the purchase of our products and services while they perform a comparison of Microsoft's competing offerings. Moreover, the resulting competitive pressures could lead to price reductions for our offerings and reduce our revenue and gross profit accordingly and our operating results could be negatively impacted.

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If the markets for Windows Embedded and/or Windows Mobile operating systems fail to develop further, develop more slowly than expected, or decline, our business and operating results may be materially harmed.

Because a significant portion of our revenue to date has been generated by software and services targeted at customers and devices utilizing the various Microsoft Windows Embedded and Windows Mobile operating systems, if the markets for these systems or platforms fail to develop further, or develop more slowly than expected, or decline, our business and operating results could be negatively impacted. Market acceptance of Microsoft Windows Embedded and Windows Mobile operating systems will depend on many factors, including:

Microsoft's development and support of various Windows Embedded and Windows Mobile markets. As the developer and primary promoter of several versions of operating systems aimed at Windows Embedded and Windows Mobile markets, if Microsoft were to decide to discontinue or lessen its support of these operating systems and platforms, potential customers could select competing operating systems, which could reduce the demand for our Microsoft Windows Embedded and Windows Mobile related software products and engineering services, from which a significant portion of our revenue is generated today;

The ability of the Microsoft Windows Embedded and/or Windows Mobile operating systems to compete against existing and emerging operating systems for the smart connected systems market, including: iOS from Apple, Inc., VxWorks and Linux from WindRiver Systems Inc.; Android from Google Inc.; QNX; Blackberry from Research In Motion Limited (RIM); and other proprietary operating systems. Microsoft Windows Embedded and Windows Mobile operating systems may be unsuccessful in capturing a significant share of the smart connected systems market, or in maintaining its market share;

The acceptance by customers of the mix of features and functions offered by Microsoft Windows Embedded and Windows Mobile operating systems; and

The willingness of software developers to continue to develop and expand the applications that run on Microsoft Windows Embedded and Windows Mobile operating systems. To the extent that software developers write applications for competing operating systems that are more attractive to users than those available on Microsoft Windows Embedded and Windows Mobile operating systems, this could cause potential customers to select competing operating systems.

MyFord Touch-Related Risk Factors

If we do not obtain additional work on the MyFord Touch program, our future revenue and gross profit would decrease and our operating results would be adversely affected.

We began working on the MyFord Touch infotainment project with Ford in the second quarter of 2008 and continue to work on the program. Since inception of the program through December 31, 2011, our contractual relationship was with Ford. Effective January 1, 2012, our contractual relationship for the MyFord Touch program shifted from Ford to Microsoft, as Microsoft has become the primary vendor to Ford for this program. Revenue from the MyFord Touch program comprised \$4.5 million, or 5%, of our total revenue, in 2013, and \$6.4 million, or 6%, of our total revenue in 2012. We currently expect this project work to continue in 2014 but expect revenue from the MyFord Touch program to be lower, albeit still significant in 2014, than it was in 2013 due to the lower level of personnel resources utilized on the program. Our statement of work with Microsoft currently runs through June 30, 2014. While we expect to be actively involved in future projects with Microsoft and Ford beyond June 30, 2014, if our role on MyFord Touch is scaled back or eliminated beyond that point our revenue and resulting gross profit would suffer and negatively impact our operating results.

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General Business-Related Risk Factors

Our marketplace is extremely competitive, which may result in price reductions, lower gross profit margins and loss of market share.

The market for device software and services is extremely competitive. We face competition from the following:

Our current and potential customers' internal research and development departments, which may seek to develop their own software solutions which compete with our proprietary software products and engineering services;

Engineering service firms, including off-shore development companies, such as Adeneo, SymphonyTeleca and Wipro;

ODMs, particularly those in Taiwan and China, which have added or are adding software development capabilities to their offerings;

Contract manufacturers which have added or are adding software development capabilities to their offerings;

Mobile and embedded test automation providers including Perfecto Mobile, mVerify, JAMO Solutions, SmartBear Software (AutomatedQA), TestPlant (eggPlant) and Keynote. In this market we also compete against customers' internally created tools and against manual testing;

Microsoft Windows Embedded and Windows Mobile operating system distributors such as Arrow Electronics, Inc. Avnet, Inc. and Synnex Corporation in Taiwan;

Marketing agencies and specialized vendors who provide mobile application services; and

We will encounter increasing competition in the growing Internet of Things market from a number of additional software and service providers as we expand our focus on this market in 2014 and beyond.

Some of our competitors focus on only one aspect of our business or offer complementary products which can be integrated with our products. As we develop and bring to market new software products and service offerings, we may begin competing with companies with which we have not previously competed. Further, as we expand the geographic markets into which we sell our software solutions and related services, or increase our penetration therein, we may expect to increasingly compete with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share. Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced software and service revenue opportunities for us. The barrier to entering the market as a provider of Microsoft-based smart connected system software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded and Windows Mobile operating system software and services. These systems integrators are given substantially the same access by Microsoft to the Microsoft technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the connected device market, and as new products and technologies are introduced.

Expected operating efficiencies from our restructuring plans may not be realized as anticipated.

In the fourth quarter of 2013, we effected a restructuring that included a workforce reduction and the closure of our offices in Beijing, China and Munich, Germany. The restructuring was intended to reduce expenses, both service and proprietary software cost of sales and all areas of operating expenses, by approximately \$4 million annually and better align our organizational structure with our strategic focus. Factors which

may affect the potential operating efficiencies we realize from our restructuring plans include the adverse impact of job eliminations and office closings, uncertainties associated with loss of customer and vendor confidence, potential

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negative impact on sales and customer service as well as factors outside of our control such as changes in the economic environment. We cannot be certain that the anticipated benefits will be realized under our restructuring plans, which could result in further restructuring efforts. If our restructuring plans are not successful, our business and results of operations may be negatively impacted.

Management turnover creates uncertainties and could harm our business.

We had significant changes in executive leadership during 2013 and more could occur. Jerry Chase was appointed as President and Chief Executive Officer of the Company in February 2014. Mr. Chase joined our Board of Directors in July 2013 and had served as our interim Chief Executive Officer since September 23, 2013, after Brian Crowley stepped down as President and Chief Executive Officer and from the Board of Directors. In October 2013, John Traynor, Senior Vice-President, Products left the company as part of the restructuring. In addition, Mike Stipe, Senior Vice President, Worldwide Sales and Marketing departed in December 2013. At that time, Mark Whiteside, Senior Vice President, Professional Services took on the additional role of Senior Vice President of US Solutions and International Sales.

Changes to strategic or operating goals, which can often times occur with the appointment of new executives, can create uncertainty, may negatively impact our ability to execute quickly and effectively, and may ultimately be unsuccessful. In addition, executive leadership transition periods are often difficult as the new executives gain detailed knowledge of our operations, and friction can result from changes in strategy and management style. Management turnover inherently causes some loss of institutional knowledge, which can negatively affect strategy and execution. Until we integrate new personnel, and unless they are able to succeed in their positions, we may be unable to successfully manage and grow our business, and our financial condition and profitability may suffer.

Further, to the extent we experience additional management turnover, competition for top management is high and it may take months to find a candidate that meets our requirements. If we are unable to attract and retain qualified management personnel, our business could suffer.

Our ability to maintain or grow our proprietary software revenue is contingent on our ability to bring to market competitive, unique offerings that keep pace with technological changes and needs. If we are not successful in doing so, our business would be negatively impacted.

Proprietary software product revenue provides us with much higher gross profit margins than we typically receive from third-party software products and our engineering service offerings and provide other advantages as well. Increasing the number and amount of proprietary products we sell is an important part of our growth strategy. Our ability to maintain and increase the revenue contribution from proprietary software products is contingent on our ability to enhance the features and functionality of our current proprietary products as well as to devise, develop and introduce new products. There can be no assurance that we will be able to maintain or expand the number of proprietary products that we sell, and our failure to do so could negatively impact revenue and our operating results.

We may experience delays in our efforts to develop new products and services, and these delays could cause us to miss market opportunities which could negatively impact our revenue and operating results.

The market for our software and services evolves rapidly. As a result, the life cycles of our products and services are difficult to estimate. To be successful, we believe we must continue to enhance our current offerings and provide new software and service offerings with attractive features, prices and terms that appeal to our customers. We have experienced delays in new software and service offering introductions in the past and may do so again in the future. Our revenue and operating results may be negatively impacted if we delay releases of new products, product enhancements and/or new services offerings, or if we fail to accurately anticipate our customers' needs or technical trends and are unable to introduce new products and service offerings into the market successfully. In addition, our customers may defer or forego purchases of our products and/or services if we, Microsoft, our competitors or major hardware, systems or software vendors introduce or announce new products.

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Our future success depends upon our customers ability to successfully sell their products incorporating our technology, and to continue buying our services.

Even if a customer selects us to provide software and services, the customer may not ultimately market and sell its product successfully. A cancellation or change in plans by a customer, whether from lack of market acceptance of its products or otherwise, could cause us to lose revenue that we had anticipated and our revenue and operating results would suffer. Also, our revenue and operating results could suffer if a significant customer reduces or delays orders during our sales cycle or chooses not to release products that contain our technology.

If the market for smart, connected systems evolves based on technologies that we do not support, our revenue may not grow as anticipated, if at all, and our business would be harmed.

The technologies used in smart, connected systems change very rapidly and it is often difficult to foresee and predict which application processors, operating systems, connectivity, testing and application development technologies will gain a foothold in device development. As a smaller company we can invest our resources in a limited number of technologies and as such must make forward investments in developing products and capabilities to support the technologies that we choose. If we make investments in technologies that do not gain traction in device development, our profit potential is uncertain and our revenue may not develop as anticipated. We are dependent upon the broad acceptance and adoption by businesses and consumers of a wide variety of device technologies, which will depend on many factors, including:

The development of content and applications for smart, connected systems;

The evolution of industry standards or the necessary infrastructure that facilitate the distribution of content over the Internet to these systems via wired and wireless telecommunications systems, satellite or cable; and

The amount of discretionary funds companies and individuals have to spend for the latest technologies.

The success and profitability of our service offerings are contingent on our ability to differentiate these offerings adequately in the marketplace, which is, in turn, contingent on our ability to retain our engineering personnel and defend our billing rate structure against those of our competitors, including those using significant lower-cost offshore resources. If we are unable to do so successfully, our business could be harmed.

We are a leader in providing engineering services to customers developing smart devices. Our market differentiation is created through several factors, including our experience with a variety of smart connected system platforms and applications. Our differentiation is contingent, in part, on our ability to attract and retain employees with this expertise, a significant portion of which are currently based in the United States. To the extent we are unable to retain critical engineering services talent and/or our competition is able to deliver the same services by using significant lower-cost offshore resources, our service revenue and operating results could be negatively impacted.

The success and profitability of our service engagements are contingent upon our ability to scope and bid engagements and deliver our services profitably. If we are unable to do so, our service revenue service gross profit margin and operating results could be negatively impacted.

Various factors may cause the total cost of service projects to exceed the original estimate provided to the customer or the contractual maximum in the case of fixed price contracts, including specification changes, customer deliverable delays, inadequate scoping and inefficient service delivery. If we are unable to adequately scope, bid and deliver on service engagements successfully, our service revenue, service gross margin and operating results could be negatively impacted. In addition, depending on the cause of an overrun for a given customer and project, we may also decide to provide pricing concessions to that customer which could negatively impact our service revenue, service gross profit and operating results.

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We have periodically entered into engineering service agreements in which we have agreed to perform our engineering service work for lower up-front fees, or for no fees, in exchange for future royalties or per unit fees. There is no guarantee that these arrangements will produce the strategic or economic returns as anticipated.

We have entered into contracts that involve reducing or eliminating up-front engineering service fees in return for a per-device/chip royalty or fee that is earned as our customers ship their devices or chips, and we may enter into more such agreements in the future. Because we are delaying revenue past the point where our services are performed, there is a risk that our customers may cancel their projects or that their devices or chips may not be successful in the market, which could negatively impact our revenue and operating results.

Cooperation and support from silicon vendors is critical for the success of our products and related services that are developed for their particular silicon architecture. Such cooperation cannot be assured.

We have developed, and continue to develop, software and service offerings based on certain silicon architectures. Due to the nature of the industry we serve and the products we develop, it is necessary for us to make certain assumptions regarding which silicon vendors will be successful in the various markets we serve and upon which we are making investments. It is therefore important that there is ongoing support from the SVs in the marketplace for these silicon architectures. There can be no assurance that TI, Qualcomm, Freescale, Intel or any of the other SVs will continue to pursue and support the markets that we have been targeting. If the SVs do not support our efforts going forward, our revenue and operating results could be negatively impacted.

The long sales cycle of our products and services makes our revenue susceptible to fluctuations.

Our sales cycle is typically three to nine months because the expense and complexity of the software and service offerings we sell generally require a lengthy customer approval process and may be subject to a number of significant risks over which we have little or no control, including:

Customers' budgetary constraints and internal acceptance review procedures;

The approval cycles for our customers may be longer due to economic uncertainties;

The timing of budget cycles; and

The timing of customers' competitive evaluation processes.

In addition, to successfully sell our software and engineering service offerings, we must frequently educate our potential customers about the full benefits of our software and services, which can require significant time. If our sales cycle further lengthens unexpectedly, it could adversely affect the timing of our revenue, which could cause our quarterly results to fluctuate.

Erosion of the financial condition of our customers could adversely affect our business.

Our business could be adversely affected if the financial condition of our customers erodes because such erosion could reduce demand from those customers for our software and engineering services. This could also cause them to terminate their relationships with us, and/or could increase the risk that such customers default on their payment obligations to us. Additionally, while we believe that our allowance for doubtful accounts is adequate, economic trends may cause more companies to default or cease operations, in which case our allowances may not cover actual losses, which could adversely affect our operating results.

Our business and operations would be adversely impacted in the event of a failure or interruption of our information technology infrastructure.

The proper functioning of our information technology infrastructure is critical to the efficient operation and management of our business. Our technology infrastructure is vulnerable to cyber-attacks, computer viruses,

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worms and other malicious software programs, physical and electronic break-ins, sabotage and similar disruptions from unauthorized tampering with our computer systems. We believe that we have adopted appropriate measures to mitigate potential risks to our technology infrastructure and our operations from these information technology-related and other potential disruptions. However, given the unpredictability of the timing, nature and scope of such disruptions, we could potentially be subject to downtimes, operational delays, other detrimental impacts on our operations or ability to provide products and services to our customers, the compromising of confidential or otherwise protected information, destruction or corruption of data, security breaches, other manipulation or improper use of our systems and networks, financial losses from remedial actions, loss of business or potential liability, and/or damage to our reputation, any of which could have a material adverse effect on our cash flows, competitive position, financial condition or results of operations.

We may be subject to product liability claims that could result in significant costs.

Our software license and service agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that these provisions may be ineffective under the laws of certain jurisdictions or that our customers may not agree to these limitations. Although we have not experienced any product liability claims to date, the sale and support of our products and services may be subject to such claims in the future. There is a risk that any such claims or liabilities may exceed, or fall outside, the scope of our insurance coverage, and we may be unable to retain adequate liability insurance in the future. A product liability claim brought against us, whether successful or not, could negatively impact our business and operating results.

Negative business conditions, changes in useful lives, and other factors may negatively affect the carrying value of the intangible assets and goodwill we have acquired.

In the third quarter of 2011, we acquired MPC Data, Ltd. including certain intangible assets with a carrying value of \$758,000 and goodwill of \$3.7 million as of December 31, 2013. Although we expect to generate cash from the intangible assets in the future, and do not foresee any impairment of our goodwill, it is possible that we may be required to reassess the carrying value of these assets in the future if certain negative business conditions occur such as negative results of our business associated with our intangible assets or a low stock price. Any reduction in the carrying value of these intangible assets or goodwill would result in an impairment charge that would negatively impact our operating results. Further, business conditions and other factors may also require us to reassess the useful lives associated with intangible assets.

Past acquisitions have proven difficult to integrate, and recent or future acquisitions, if any, could disrupt our business, dilute shareholder value and negatively affect our operating results.

We have acquired the technologies, assets and/or operations of other companies in the past and may acquire or make investments in companies, products, services and technologies in the future as part of our growth strategy. If we fail to properly evaluate, integrate and execute on our acquisitions and investments, our business and prospects may be seriously harmed. To successfully complete an acquisition, we must properly evaluate the technology, market and management team, accurately forecast the financial impact of the transaction, including accounting charges and transaction expenses, integrate and retain personnel, combine potentially different corporate cultures and effectively integrate products and research and development, sales, marketing and support operations. If we fail to do any of these, we may suffer losses and impair relationships with our employees, customers and strategic partners. Additionally, management may be distracted from day-to-day operations. We also may be unable to maintain uniform standards, controls, procedures and policies, which are especially critical in light of Sarbanes-Oxley and other corporate governance requirements, and significant demands may be placed on our management and our operations, information services and financial, legal and marketing resources. Finally, acquired businesses sometimes result in unexpected liabilities and contingencies, which may involve compliance with foreign laws, payment of taxes, labor negotiations or other unknown costs and expenses, which could be significant.

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We may not be able to raise additional capital if required to support our business.

If we need to raise additional operating capital, we may find that our access to equity and debt capital markets is limited or blocked entirely. In the past, our stock has traded at low volumes and overall investor confidence in the stock market could falter. This could make it difficult or impossible to sell additional shares on the public markets. In addition, it may be difficult and costly to obtain debt financing and we may be unable to borrow additional funds at acceptable cost, or at all, should the need arise. If we are unable to raise capital as necessary, it may adversely affect our ability to invest in products or fund operations, which would materially harm our business and negatively affect operating results.

Taxing jurisdictions in the United States are becoming more aggressive with tax legislation and tax collection, particularly states facing significant budget deficits, which could expose us to additional tax liability that we have not been subject to in the past.

We make sales in many jurisdictions across the United States, most of which we do not have nexus in and, therefore, are not subject to sales, franchise, income and other state and local taxes. Particularly in light of state revenue deficits, taxing jurisdictions have become more aggressive in defining nexus, among other things, which could result in us achieving nexus, or potentially achieving nexus in significantly more tax jurisdictions. If this occurs and unless we are able to pass through this cost to our customers, our tax expense will increase which will negatively affect our results of operations. Further, because state and local tax laws are becoming increasingly complex, our cost to monitor our state and local tax compliance will increase which will negatively affect our results of operations. Additionally, there can be no assurance that we do not currently have unknown tax exposure in a state or local tax jurisdiction because of recent tax law changes which we are unaware of and the resulting liability could be significant and would negatively affect our results of operations.

There may be restrictions on the use of our net operating loss and tax credit carryforwards due to a tax law ownership change.

Section 382 of the U.S. Internal Revenue Code restricts the ability of a corporation that undergoes an ownership change to use net operating loss and tax credit carryforwards. At December 31, 2013, we had approximately \$55.6 million of federal and \$9.3 million of state net operating loss carryforwards, and \$2.7 million of tax credit carryforwards. Under the applicable tax rules, an ownership change occurs if greater than five percent shareholders of an issuer's outstanding common stock collectively increase their ownership percentage by more than 50 percentage points over a rolling three-year period. We have performed analyses of possible ownership changes which included consideration of a third-party study, and do not believe that an ownership change (as defined by this Section) has occurred. However, if a tax law ownership change has occurred of which we are not aware, or if a tax law ownership change occurs in the future, we may have to adjust the valuation of our deferred tax assets, and could be at risk of having to pay income taxes notwithstanding the existence of our sizable carryforwards. Further, to the extent that we have utilized our carryforwards from prior years, the existence of a previous tax law ownership change that we did not account for could result in liability for back taxes, interest, and penalties. If we are unable to utilize our carryforwards and/or if we previously utilized carryforwards to which we were not entitled, it would negatively impact our business, financial condition and operating results.

Intellectual Property-Related Risk Factors

Our software and service offerings could infringe the intellectual property rights of third parties, which could expose us to additional costs and litigation and could adversely affect our ability to sell our products and services or cause shipment delays or stoppages.

It is difficult to determine whether our software and engineering services infringe third-party intellectual property rights, particularly in a rapidly evolving technological environment in which technologies often overlap and where there may be numerous patent applications pending, many of which are confidential when filed. If we

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were to discover that one of our software or service offerings, or a product based on one of our reference designs, violated a third-party's proprietary rights, we may not be able to obtain a license on commercially reasonable terms, or at all, to continue offering that product or service. Similarly, third parties may claim that our current or future software products and services infringe their proprietary rights, regardless of whether such claims have merit. Any such claims could increase our costs and negatively impact our business and operating results. In certain cases, we have been unable to obtain indemnification against claims that third-party technology incorporated into our software products and services infringe the proprietary rights of others. However, any indemnification we do obtain may be limited in scope or amount. Even if we receive broad third-party indemnification, these entities may not have the financial capability to indemnify us in the event of infringement. In addition, in some circumstances we are required to indemnify our customers for claims made against them that are based on our software products or services. There can be no assurance that infringement or invalidity claims related to the software products and services we provide, or arising from the incorporation by us of third-party technology, and claims for indemnification from our customers resulting from such claims, will not be asserted or prosecuted against us. Some of our competitors have, or are affiliated, with companies with substantially greater resources than we have, and these competitors may be able to sustain the costs of complex intellectual property litigation to a greater degree and for longer periods of time than we could. In addition, we expect that software developers will be increasingly subject to infringement claims as the number of products and competitors in the software industry grows, and as the functionality of products in different industry segments increasingly overlap. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources in addition to potential product redevelopment costs and delays. Furthermore, if we were unsuccessful in resolving a patent or other intellectual property infringement action claim against us, we may be prohibited from developing or commercializing certain of our technologies and products, or delivering services based on the infringing technology, unless we obtain a license from the holder of the patent or other intellectual property rights. There can be no assurance that we would be able to obtain any such license on commercially favorable terms, or at all. If such license is not obtained, we would be required to cease these related business operations, which could negatively impact our business, revenue and operating results.

If we fail to adequately protect our intellectual property rights, competitors may be able to use our technology or trademarks, which could weaken our competitive position, reduce our revenue and increase our costs.

If we fail to adequately protect our intellectual property, our competitive position could be weakened and our revenue and operating results adversely affected. We rely primarily on confidentiality procedures and contractual provisions as well as a combination of patent, copyright, trade secret and trademark laws, to protect our intellectual property. These laws and procedures provide only limited protection. It is possible that another party could obtain patents that block our use of some, or all, of our software and services. If that occurred, we would need to obtain a license from the patent holder or design around those patents. The patent holder may or may not choose to make a license available to us at all, or on acceptable terms. Similarly, it may not be possible to design around a blocking patent. In general, there can be no assurance that our efforts to protect our intellectual property rights through patent, copyright, trade secret and trademark laws will be effective to prevent misappropriation of our technology, or to prevent the development and design by others of products or technologies similar to or competitive with those developed by us.

We frequently license the source code of our software products and the source code results of our services to customers. There can be no assurance that customers with access to our source code will comply with the license terms or that we will discover any violations of the license terms or, in the event of discovery of violations, that we will be able to successfully enforce the license terms and/or recover the economic value lost from such violations. To license some of our software products, we rely in part on shrinkwrap and clickwrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. As with other software, our software products are susceptible to unauthorized copying and uses that may go undetected, and policing such unauthorized use is difficult. A significant portion of our marks include the word BSQUARE. Other companies use forms of BSQUARE in their marks alone, or in combination with other

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words, and we cannot prevent all such third-party uses. We license certain trademark rights to third parties. Such licensees may not abide by our compliance and quality control guidelines with respect to such trademark rights. Any of these outcomes could negatively impact our brand, dilute its recognition in the marketplace, or confuse potential customers, all of which could harm our business.

The computer software market is characterized by frequent and substantial intellectual property litigation, which is often complex and expensive, and involves a significant diversion of resources and uncertainty of outcome. Litigation may be necessary in the future to enforce our intellectual property or to defend against a claim of infringement or invalidity. Litigation could result in substantial costs and the diversion of resources and could negatively impact our business and operating results.

Our software or hardware products or the third-party hardware or software integrated with our products or delivered as part of our service offerings may suffer from defects or errors that could impair our ability to sell our products and services.

Software and hardware components as complex as those needed for smart connected systems frequently contain errors or defects, especially when first introduced or when new versions are released. We have had to delay commercial release of certain versions of our products until problems were corrected and, in some cases, have provided product enhancements to correct errors in released products. Some of our contracts require us to repair or replace products that fail to work. To the extent that we repair or replace products our expenses may increase. In addition, it is possible that by the time defects are fixed, the market opportunity may decline which may result in lost revenue. Moreover, to the extent that we provide increasingly comprehensive products and services, particularly those focused on hardware, and rely on third-party manufacturers and suppliers to manufacture these products, we will be dependent on the ability of third-party manufacturers to correct, identify and prevent manufacturing errors. Errors that are discovered after commercial release could result in loss of revenue or delay in market acceptance, diversion of development resources, damage to our reputation and increased service and warranty costs, all of which could negatively impact our business and operating results.

If we are unable to license key software from third parties, our business could be harmed.

We sometimes integrate third-party software with our proprietary software and engineering service offerings or sell such third-party software offerings on a standalone basis (e.g. Microsoft Windows Embedded operating systems under our ODA with Microsoft). If our relationships with these third-party software vendors were to deteriorate, or be eliminated in their entirety, we might be unable to obtain licenses on commercially reasonable terms, if at all. In the event that we are unable to obtain these third-party software offerings, we would be required to develop this technology internally, assuming it was economically or technically feasible, or seek similar software offerings from other third parties assuming there were competing offerings in the marketplace, which could delay or limit our ability to introduce enhancements or new products, or to continue to sell existing products and engineering services, thereby negatively impacting our revenue and operating results.

Governance-Related Risk Factors

It might be difficult for a third-party to acquire us even if doing so would be beneficial to our shareholders.

Certain provisions of our articles of incorporation, bylaws and Washington law may discourage, delay or prevent a change in the control of us or a change in our management, even if doing so would be beneficial to our shareholders. Our Board of Directors has the authority under our amended and restated articles of incorporation to issue preferred stock with rights superior to the rights of the holders of common stock. As a result, preferred stock could be issued quickly and easily with terms calculated to delay or prevent a change in control of our company or make removal of our management more difficult. In addition, our Board of Directors is divided into three classes. The directors in each class serve for three-year terms, one class being elected each year by our shareholders. This system of electing and removing directors may discourage a third party from making a tender

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offer or otherwise attempting to obtain control of our company because it generally makes it more difficult for shareholders to replace a majority of our directors. In addition, Chapter 19 of the Washington Business Corporation Act generally prohibits a target corporation from engaging in certain significant business transactions with a defined acquiring person for a period of five years after the acquisition, unless the transaction or acquisition of shares is approved by a majority of the members of the target corporation's Board of Directors prior to the time of acquisition. This provision may have the effect of delaying, deterring or preventing a change in control of our company. The existence of these anti-takeover provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

International Operations-Related Risk Factors

Our international operations expose us to greater intellectual property, management, collections, regulatory and other risks.

Customers outside of North America generated 13% of our total revenue in 2013 and 20% in 2012. We currently have sizable operations outside of North America in Taiwan and the United Kingdom and also have a minor sales and support presence in Japan. In 2013, we closed our operations in Korea, China and Germany. Our international activities and operations expose us to a number of risks, including the following:

Greater difficulty in protecting intellectual property due to less stringent foreign intellectual property laws and enforcement policies;

Longer collection cycles than we typically experience in North America;

Unfavorable changes in regulatory practices and tariffs;

Compliance with complex regulatory regimes or restrictions on import and export of our goods and services;

Complex and/or adverse tax laws and/or changes thereto. Additionally, we may be subject to income, withholding and other taxes for which we may realize no current benefit despite the existence of significant net operating loss and tax credit carryforwards in the U.S.;

Loss or reduction of withholding tax exemptions;

The impact of fluctuating exchange rates between the U.S. dollar and foreign currencies;

General economic and political conditions in international markets which may differ from those in the U.S.;

Increased exposure to potential liability under the Foreign Corrupt Practices Act;

Added cost and administrative burden associated with creating and operating business structures in other jurisdictions;

Potential labor costs and risks associated with employees and labor laws in other geographies; and

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The inherent risks of working in a certain highly regulated and/or controlled economies where relationships between company management and government officials is critical to timely processing of approvals required to conduct business. These risks could have a material adverse effect on the financial and managerial resources required to operate our foreign offices, as well as on our future international revenue, which could negatively impact our business and operating results.

As our customers seek more cost-effective locations to develop and manufacture their products, particularly overseas locations, our ability to continue to sell these customers our software products and services could be limited, which could negatively impact our revenue and operating results.

Due to competitive and other pressures, some of our customers have moved, and others may seek to move, the development and manufacturing of their smart, connected systems to overseas locations, which may limit our

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ability to sell these customers our software and services. As an example, under our ODA with Microsoft, we are currently only able to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba), Mexico, the European Union and the European Free Trade Association. If our customers, or potential customers, move their manufacturing overseas we may be restricted from reselling Microsoft Windows Embedded operating systems to these customers or we would be less competitive, which could negatively impact our revenue and operating results.

Item 1B. *Unresolved Staff Comments.*

None

Item 2. *Properties.*

As of December 31, 2013, our corporate headquarters are located in 43,400 square feet of leased space in a single location in Bellevue, Washington. We amended the underlying lease in August 2013 which extended the lease term to May 2020 and reduced the leased square footage to 24,000 square feet effective upon completion of leasehold improvements that are expected to be completed in early 2014.

In North America, we also lease office space in San Diego, California; Boston, Massachusetts; and Akron, Ohio. We lease office space overseas in Tokyo, Japan, Taipei, Taiwan; and Trowbridge, United Kingdom. Our facilities have sufficient capacity to support our current operational needs as well as short-term growth plans.

Item 3. *Legal Proceedings.*

None.

Item 4. *Mine Safety Disclosures.*

None.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**
Market Information

Our common stock is traded on the NASDAQ Global Select Market under the symbol BSQR. The following table sets forth the high and low closing prices for our common stock for the periods indicated, as reported by the NASDAQ Global Select Market.

| | High | Low |
|--------------------------------------|---------|---------|
| Year Ended December 31, 2013: | | |
| First Quarter | \$ 3.57 | \$ 2.85 |
| Second Quarter | \$ 3.18 | \$ 2.64 |
| Third Quarter | \$ 2.96 | \$ 2.69 |
| Fourth Quarter | \$ 3.58 | \$ 2.61 |
| Year Ended December 31, 2012: | | |
| First Quarter | \$ 4.28 | \$ 3.14 |
| Second Quarter | \$ 3.35 | \$ 2.46 |
| Third Quarter | \$ 3.19 | \$ 2.76 |
| Fourth Quarter | \$ 3.29 | \$ 2.60 |

Holders

As of January 31, 2014, there were 127 holders of record of our common stock. Because many shares of our common stock are held by brokers and other institutions on behalf of shareholders, we are unable to determine the total number of shareholders represented by these holders of record.

Dividends

We have never paid cash dividends on our common stock. We currently intend to retain any future earnings to fund future development and growth and, therefore, do not anticipate paying any consistent cash dividends in the foreseeable future. Our Board of Directors has, however, periodically considered implementing a share repurchase program and/or a special one-time cash dividend.

Item 6. Selected Financial Data.

Not Applicable.

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Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations.*

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. This Management's Discussion and Analysis of Financial Condition and Results of Operations may contain some statements and information which are not historical facts but are forward-looking statements. For a discussion of these forward-looking statements, and of important factors that could cause results to differ materially from the forward-looking statements contained in this report, see Item 1 of Part I, Business Forward-Looking Statements, and Item 1A of Part I, Risk Factors.

Overview

We provide software solutions and related engineering services to companies that develop smart, connected systems. A smart, connected system is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® Embedded Compact) and is usually connected to a network or data cloud via a wired or wireless connection. Examples of smart, connected systems 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, vending machines, in-vehicle telematics and entertainment devices. We primarily focus on smart, connected systems that utilize Microsoft Windows Embedded and Windows Mobile operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX.

We have been providing software solutions for smart, connected systems since our inception. Our customers include world class OEMs, ODMs and Enterprises, as well as SVs and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales. In the case of Enterprises, our customers include those which develop, market and distribute smart, connected systems on their own behalf as well as those that purchase systems from OEMs or ODMs and require additional software, integration and/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

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 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 such engagements before we have received a signed contract.

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. Fixed-price service agreements, and certain time and materials service agreements with capped fee structures, are accounted for using the percentage-of-completion method assuming reasonable estimates of completion can be made. We use the percentage-of-completion method of accounting because we believe it is the most accurate method to recognize revenue based on the nature and scope of these engineering service contracts; we believe it is a better measure of periodic income results than other methods and better matches revenue recognized with the costs incurred. Percentage of completion is measured based primarily on

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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. Significant judgment is required when estimating total hours and progress to completion on these arrangements which 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.

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 other revenue recognition criteria are met, particularly that collectability is reasonably assured.

There are two items involving revenue recognition that require us to make more 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 our TestQuest automated testing tools. We establish VSOE of fair value for TestQuest PCS 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 measure our estimate of completion on fixed-price contracts, which in turn determines the amount of revenue we recognize, based primarily 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. 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 December 31, 2013, we were delivering engineering services under eight 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

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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 10% under in our estimates of completion on every fixed-bid contract active on December 31, 2013, our revenue would be over-stated by \$280,000 for 2013.

Intangible Assets and Goodwill

We evaluate our intangible assets for indications of impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our intangible assets were acquired through business acquisitions. Our intangible assets consist of customer relationships and non-compete agreements. Factors that could trigger an impairment analysis include significant under-performance relative to historical or projected future operating results, significant changes in the manner of our use of the acquired assets or the strategy for our overall business or significant negative industry or economic trends. If this evaluation indicates that the value of the intangible asset may be impaired, we make an assessment of the recoverability of the net carrying value of the asset over its remaining useful life. If this assessment indicates that the intangible asset is not recoverable, based on the estimated undiscounted future cash flows of the technology over the remaining useful life, we reduce the net carrying value of the related intangible asset to fair value. Any such impairment charge could be significant and could have a material adverse effect on our reported financial results.

We evaluate goodwill for impairment annually or more frequently when an event occurs or circumstances change that indicate that the carrying value may not be recoverable. Our annual testing date is December 31. We test goodwill for impairment by performing a qualitative assessment to determine whether it is more likely than not that the fair value of the reporting unit is less than the carrying amount. If it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, further testing of impairment is not performed. If it is more likely than not that the fair value of the reporting unit is less than the carrying amount, we perform a quantitative two-step impairment test.

Stock-Based Compensation

Our stock-based compensation expense for stock options 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 as determined based on the number of shares granted and the quoted price of our common stock on the date 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 and expected future activity. To the extent our actual forfeiture rate is different from our estimates, 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.

Table of Contents**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 or income taxes, 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. We estimate the valuation allowance related to our deferred tax assets on a quarterly basis.

Our sales may be subject to other taxes, particularly withholding taxes, due to our sales to customers in countries other than the United States. 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 varied 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.

| | Year Ended December 31, | |
|-------------------------------------|------------------------------------|-------------|
| | 2013 | 2012 |
| Revenue: | | |
| Software | 80% | 75% |
| Service | 20 | 25 |
| Total revenue | 100 | 100 |
| Cost of revenue: | | |
| Software | 66 | 60 |
| Service | 18 | 21 |
| Total cost of revenue | 84 | 81 |
| Gross profit | 16 | 19 |
| Operating expenses: | | |
| Selling, general and administrative | 17 | 14 |
| Research and development | 3 | 4 |
| Total operating expenses | 20 | 18 |
| Income (loss) from operations | (4) | 1 |
| Other income, net | 0 | 0 |
| Income (loss) before income taxes | (4) | 1 |
| Income tax expense | (2) | 0 |
| Net income (loss) | (6)% | 1% |

Table of Contents**Comparison of the Years Ended December 31, 2013 and 2012*****Revenue***

Our revenue is generated from the sale of software, both our own proprietary software and third-party software that we resell, and the sale of engineering services. Total revenue decreased \$9.3 million, or 9%, to \$92.1 million in 2013 from \$101.4 million in 2012. This decrease was driven by lower sales of third party Windows Mobile operating systems and a decline in proprietary software and service revenue, partially offset by an increase in sales of the third party Microsoft Windows Embedded operating systems and Adobe Flash revenue.

Revenue from our customers outside of North America decreased \$7.7 million, or 39%, to \$11.7 million in 2013, from \$19.8 million in 2012. Revenue from our customers outside of North America represented 13% of our total revenue in 2013, compared to 20% in 2012. The decrease in non-North American revenue in 2013 was primarily attributable to lower sales of Windows Mobile operating systems, lower service revenue and lower proprietary software sales in Asia. Specifically, a portion of the Windows Mobile operating systems sales decline resulted from the expiration of our Korea distribution rights on October 31, 2012, as prior sales in Korea contributed \$4.5 million of Windows Mobile operating systems revenue in 2012.

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, support and maintenance revenue, and royalties from certain engineering service contracts. Software revenue for 2013 and 2012 was as follows (dollars in thousands):

| | Year Ended December 31, | |
|--|------------------------------------|-------------|
| | 2013 | 2012 |
| Software revenue: | | |
| Third-party software | \$ 70,891 | \$ 71,130 |
| Proprietary software | 2,513 | 4,710 |
| Total software revenue | \$ 73,404 | \$ 75,840 |
| Software revenue as a percentage of total revenue | 80% | 75% |
| Third-party software revenue as a percentage of total software revenue | 97% | 94% |

The vast majority of our third-party software revenue is comprised of sales of Microsoft Windows Embedded and Windows Mobile operating systems. Third-party software revenue decreased \$239,000, or 0.3%, in 2013 compared to the prior year.

Proprietary software revenue decreased \$2.2 million, or 47%, in 2013 compared to 2012 driven by a significant one-time HTML5 sale in Japan in 2012, a decline in Handset Certification Platform revenue from our customers in China who did not renew their subscription contracts, a decline in Testquest licensing revenue and lower support revenue.

Service revenue

Service revenue for 2013 and 2012 was as follows (dollars in thousands):

| | Year Ended December 31, | |
|-----------------|------------------------------------|-------------|
| | 2013 | 2012 |
| Service revenue | \$ 18,704 | \$ 25,554 |

Service revenue as a percentage of total revenue

20%

25%

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Service revenue decreased \$6.9 million, or 27%, in 2013 as compared to the prior year. This decrease was due to a \$3.8 million decline in North America service revenue driven primarily by a \$1.9 million decrease associated with the MyFord Touch Program and net decreases from other North America customers. We also experienced a \$1.8 million decline in Japan and a \$1.0 million decline in EMEA due to decreases in activity from large customers.

Microsoft Corporation (Microsoft) became our largest engineering services customer during the first quarter of 2012, replacing Ford Motor Company (Ford), as Microsoft replaced Ford as the invoiced customer on the MyFord Touch program. We continue to work on the MyFord Touch, a project we began with Ford during the second quarter of 2008; however, we now conduct these services through an agreement with Microsoft. During the initial project with Ford, we provided hardware design and implementation, platform level software development, application level software development, quality assurance services and systems integration services. The project has transitioned since the initial project such that we are now primarily 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. The MyFord Touch program contributed \$4.5 million in service revenue in 2013 compared to \$6.4 million in 2012 representing a decline of \$1.9 million or 30%. The decrease is attributable to a reduction in the number of engineers working on the MyFord Touch project as the amount of work on the increasingly mature platform has declined.

Gross profit and gross margin

Cost of software revenue consists primarily of the cost of third-party software products payable to third-party vendors and support costs associated with our proprietary software products. Cost of service revenue consists primarily of salaries and benefits, contractor costs and re-billable expenses, related facilities and depreciation costs, and amortization of certain intangible assets related to acquisitions.

Gross profit on the sale of third-party software products is also positively affected by rebate credits we receive from Microsoft for the sale of Windows Embedded operating systems earned through the achievement of defined objectives. Prior to the third quarter of 2013, the earned rebate amount was treated as a reduction in software cost of sales in the quarter earned. Beginning in the third quarter of 2013, as a result of program modifications, we began treating a portion of the rebate as marketing development funds which are accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

Under this rebate program, we earned \$744,000 of rebate credits in 2013 and \$888,000 in 2012, which were treated as a reduction in cost of sales. Additionally, during 2013 we earned \$409,000 in rebate credits which will be accounted for as a reduction in marketing expense if and when qualified expenditures are made.

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

| | Year Ended December 31, | |
|-----------------------|----------------------------|-----------|
| | 2013 | 2012 |
| Software gross profit | \$ 12,966 | \$ 14,728 |
| Software gross margin | 18% | 19% |
| Service gross profit | \$ 2,059 | \$ 4,331 |
| Service gross margin | 11% | 17% |
| Total gross profit | \$ 15,025 | \$ 19,059 |
| Total gross margin | 16% | 19% |

Software gross profit and gross margin

Software gross profit decreased by \$1.8 million, or 12%, in 2013, compared to 2012, while software gross margin decreased by one percentage point. The decreases in gross profit and gross margin were primarily the result of the decline in high-margin proprietary software revenue.

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Third-party software gross margin was 16% in both 2013 and 2012. Proprietary software gross margin was 66% in 2013, compared to 78% in 2012 driven by the revenue decline compared to a relatively fixed cost of sales base.

Service gross profit and gross margin

Service gross profit decreased \$2.3 million, or 52%, in 2013 compared to 2012 driven by a \$6.9 million decline in service revenue without a commensurate decline in service cost of sales. Service gross margin was 11% in 2013, a six percentage point decrease from 17% in 2012. The margin decline was driven by a 5% increase in our cost per billable hour due to lower utilization and fixed cost increases and a decline in our realized rate per hour of 2%. During the fourth quarter of 2013, we made adjustments to reduce service related expenses to better align our costs with our future service revenue expectations which included the closure of our Beijing China delivery center.

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 \$1.1 million, or 8%, to \$15.4 million in 2013, from \$14.3 million in 2012. The increase was driven by severance and related costs associated with the departure of our former Chief Executive Officer in September 2013 and the departure of our former Senior Vice President of Worldwide Sales and Marketing in December 2013. Additionally, the increase was driven by higher sales travel and entertainment costs and legal expenses. Selling, general and administrative expenses represented 17% of our total revenue in 2013 compared to 14% of revenue in 2012.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs and related facilities and depreciation costs. Research and development expenses decreased \$843,000, or 23%, to \$2.8 million in 2013, from \$3.6 million in 2012. The decline was driven by lower wage and other expenses associated primarily with two separate cost reduction efforts one in the third quarter of 2012 and another in the fourth quarter of 2013. Research and development expenses represented 3% of total revenue in 2013 and 4% in 2012.

Other income, net

Other income consists of interest income on our cash and investments, gains and losses we may recognize on our investments, gains or losses on foreign exchange transactions and other items. Other income was \$40,000 in 2013 compared to \$103,000 in 2012, representing a decline of \$63,000 which was driven by a one-time reduction to earn-out consideration in 2012 related to the September 2011 acquisition of MPC Data, Ltd.

Income taxes

Income tax expense was \$2.2 million in 2013, compared to \$366,000 in the year-ago period, a change of \$1.8 million.

In the third quarter of 2013, we determined that it was not more likely than not that we would generate sufficient future taxable income to utilize our US deferred tax assets. As a result, we increased our deferred tax asset valuation allowance by \$2.2 million. Deferred tax assets relative to our foreign jurisdictions were not affected.

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The factors we considered in recording a full valuation allowance on our US deferred tax assets included, among other things, our recent history of losses.

Restructuring

During the fourth quarter of 2013, we effected a restructuring that included a workforce reduction and the closure of our offices in Beijing, China and Munich, Germany. The workforce reduction impacted approximately 20% of our worldwide workforce. The restructuring was intended to better align our organizational structure with our strategic focus. The staff reductions and office closures were substantially completed by the end of the fourth quarter of 2013 with some activities, including legal entity closures, continuing into 2014.

The results of this restructuring and associated asset impairment were recorded within loss from operations on our *Consolidated Statement of Operations and Comprehensive Income (Loss)*. See *Note 12: Restructuring* in our *Notes to Consolidated Financial Statements* for further information.

Liquidity and Capital Resources

As of December 31, 2013, we had \$21.1 million of cash, cash equivalents, short-term investments and restricted cash, compared to \$20.6 million at December 31, 2012. Of these amounts, \$13.5 million and \$9.9 million were classified as cash and cash equivalents at December 31, 2013 and December 31, 2012, respectively,

Restricted cash is classified as long term and was \$250,000 at December 31, 2013 and \$875,000 at December 31, 2012. This cash is restricted under the terms of our headquarters operating lease which will continue to secure that obligation through its expiration in 2020. Our working capital was \$19.8 million at December 31, 2013, compared to \$20.6 million at December 31, 2012.

Net cash provided by operating activities was \$619,000 in 2013, driven by positive net working capital changes of \$2.1 million and non-cash expenses of \$3.8 million, which were offset substantially by our net loss of \$5.3 million. Net cash provided by operating activities was \$2.5 million in 2012 driven by net income of \$916,000 and non-cash expenses of \$2.2 million, offset in part by net negative working capital changes.

Investing activities provided cash of \$3.0 million in 2013, due primarily to net proceeds of short-term investments of \$2.5 million and a \$625,000 reduction in restricted cash under the terms of our corporate headquarters lease amendment executed in August 2013. Net cash used by investing activities was \$1.2 million in 2012 driven by \$391,000 in capital expenditures and payment of contingent acquisition consideration related to MPC of \$631,000.

Financing activities generated \$51,000 in 2013 and \$205,000 in 2012, as a result of the exercise of employee stock options.

We believe that our existing cash, cash equivalents, short-term investments and long-term 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:

Minimum rents payable under operating leases total \$1.0 million in 2014, \$1.1 million in 2015 and 2016, \$1.2 million in 2017 and \$2.7 million in total thereafter; and

In conjunction with our activities under our ODAs with Microsoft, we enter OVRP commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don't meet the committed minimum unit volumes, we are obligated to pay the difference between the

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committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather, the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. However, in the event a customer is unwilling or unable to pay us, we would be negatively impacted. Based upon the credit-worthiness of our customers, our historical OVRP experience with our customers and OVRP arrangements in general, we do not believe we will incur any material liability in the current or future periods.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk.*

Not Applicable.

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Item 8. *Financial Statements and Supplementary Data.*

BSQUARE CORPORATION

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

BSQUARE Corporation

We have audited the accompanying consolidated balance sheets of BSQUARE Corporation (the Corporation) as of December 31, 2013 and 2012 and the related consolidated statements of operations and comprehensive income (loss), shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of BSQUARE Corporation as of December 31, 2013 and 2012, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Moss Adams LLP

Seattle, Washington

February 25, 2014

Table of Contents**BSQUARE CORPORATION****CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)**

| | December 31, | |
|---|------------------|------------------|
| | 2013 | 2012 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 13,510 | \$ 9,903 |
| Short-term investments | 7,295 | 9,826 |
| Accounts receivable, net of allowance for doubtful accounts of \$214 at December 31, 2013 and \$200 at December 31, 2012 | 15,893 | 16,095 |
| Deferred tax assets | 12 | 296 |
| Prepaid expenses and other current assets | 2,313 | 858 |
| Total current assets | 39,023 | 36,978 |
| Equipment, furniture and leasehold improvements, net | 411 | 759 |
| Restricted cash | 250 | 875 |
| Deferred tax assets | 304 | 2,255 |
| Intangible assets, net | 863 | 1,069 |
| Goodwill | 3,738 | 3,738 |
| Other non-current assets | 59 | 117 |
| Total assets | \$ 44,648 | \$ 45,791 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Third-party software fees payable | \$ 12,746 | \$ 11,099 |
| Accounts payable | 634 | 553 |
| Accrued compensation | 2,383 | 2,205 |
| Other accrued expenses | 1,249 | 1,732 |
| Deferred revenue | 2,177 | 837 |
| Total current liabilities | 19,189 | 16,426 |
| Deferred tax liability | 144 | 206 |
| Deferred rent | 644 | 154 |
| Commitments and contingencies | | |
| 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; 11,294,682 shares issued and outstanding at December 31, 2013 and 11,065,217 shares issued and outstanding at December 31, 2012 | 129,423 | 128,474 |
| Accumulated other comprehensive loss | (759) | (733) |
| Accumulated deficit | (103,993) | (98,736) |
| Total shareholders' equity | 24,671 | 29,005 |
| Total liabilities and shareholders' equity | \$ 44,648 | \$ 45,791 |

See notes to consolidated financial statements.

Table of Contents**BSQUARE CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)****(In thousands, except per share amounts)**

| | Year Ended December 31, | |
|---|--------------------------------|----------------|
| | 2013 | 2012 |
| Revenue: | | |
| Software | \$ 73,404 | \$ 75,840 |
| Service | 18,704 | 25,554 |
| Total revenue | 92,108 | 101,394 |
| Cost of revenue: | | |
| Software | 60,438 | 61,112 |
| Service | 16,645 | 21,223 |
| Total cost of revenue | 77,083 | 82,335 |
| Gross profit | 15,025 | 19,059 |
| Operating expenses: | | |
| Selling, general and administrative | 15,372 | 14,281 |
| Research and development | 2,756 | 3,599 |
| Total operating expenses | 18,128 | 17,880 |
| Income (loss) from operations | (3,103) | 1,179 |
| Other income, net | 40 | 103 |
| Income (loss) before income taxes | (3,063) | 1,282 |
| Income tax expense | (2,194) | (366) |
| Net income (loss) | \$ (5,257) | \$ 916 |
| Basic income (loss) per share | \$ (0.47) | \$ 0.08 |
| Diluted income (loss) per share | \$ (0.47) | \$ 0.08 |
| Shares used in calculation of income (loss) per share: | | |
| Basic | 11,174 | 10,945 |
| Diluted | 11,174 | 11,449 |
| Comprehensive income (loss): | | |
| Net income (loss) | \$ (5,257) | \$ 916 |
| Other comprehensive income (expense): | | |
| Foreign currency translation, net of tax | (24) | (114) |
| Change in unrealized gains on investments, net of tax | (2) | 12 |
| Total other comprehensive income (expense) | (26) | (102) |

| | | |
|-----------------------------|------------|--------|
| Comprehensive income (loss) | \$ (5,283) | \$ 814 |
|-----------------------------|------------|--------|

See notes to consolidated financial statements.

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BSQUARE CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except share amounts)

| | Preferred Stock | | Common Stock | | Accumulated Other Comprehensive Loss | Accumulated Deficit | Total Shareholders Equity |
|--|-----------------|--------|--------------|------------|--------------------------------------|---------------------|---------------------------|
| | Shares | Amount | Shares | Amount | | | |
| Balance, December 31, 2011 | | \$ | 10,874,050 | \$ 127,318 | \$ (631) | \$ (99,652) | \$ 27,035 |
| Exercise of stock options | | | 84,411 | 205 | | | 205 |
| Share-based compensation, including issuance of restricted stock | | | 106,756 | 951 | | | 951 |
| Comprehensive income (loss): | | | | | | | |
| Net income | | | | | | 916 | 916 |
| Foreign currency translation adjustment, net of tax | | | | | (114) | | (114) |
| Change in unrealized gains on investments, net of tax | | | | | 12 | | 12 |
| Balance, December 31, 2012 | | \$ | 11,065,217 | \$ 128,474 | \$ (733) | \$ (98,736) | \$ 29,005 |
| Exercise of stock options | | | 36,050 | 51 | | | 51 |
| Share-based compensation, including issuance of restricted stock | | | 193,415 | 898 | | | 898 |
| Comprehensive income (loss): | | | | | | | |
| Net (loss) | | | | | | (5,257) | (5,257) |
| Foreign currency translation adjustment, net of tax | | | | | (24) | | (24) |
| Change in unrealized gains on investments, net of tax | | | | | (2) | | (2) |
| Balance, December 31, 2013 | | \$ | 11,294,682 | \$ 129,423 | \$ (759) | \$ (103,993) | \$ 24,671 |

See notes to consolidated financial statements.

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BSQUARE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Year Ended December 31, | |
|--|-------------------------|--------------|
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (5,257) | \$ 916 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 701 | 993 |
| Realized loss on asset disposal | 46 | |
| Stock-based compensation | 898 | 951 |
| Deferred income tax expense | 2,156 | 267 |
| Change in fair value of contingent consideration related to acquisition of business | | (135) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 202 | (2,685) |
| Prepaid expenses and other assets | (1,397) | 430 |
| Third-party software fees payable | 1,647 | 2,639 |
| Accounts payable and accrued liabilities | (207) | (468) |
| Deferred revenue | 1,340 | (400) |
| Deferred rent | 490 | (30) |
| Net cash provided by operating activities | 619 | 2,478 |
| Cash flows from investing activities: | | |
| Purchases of equipment and furniture | (194) | (391) |
| Payment of contingent consideration related to acquisition of business | | (631) |
| Proceeds from maturities of short-term investments | 10,682 | 11,611 |
| Purchases of short-term investments | (8,152) | (11,800) |
| Reduction of restricted cash | 625 | |
| Net cash provided by (used for) investing activities | 2,961 | (1,211) |
| Cash flows from financing activities proceeds from exercise of stock options | 51 | 205 |
| Effect of exchange rate changes on cash | (24) | (74) |
| Net increase in cash and cash equivalents | 3,607 | 1,398 |
| Cash and cash equivalents, beginning of year | 9,903 | 8,505 |
| Cash and cash equivalents, end of year | \$ 13,510 | \$ 9,903 |
| Supplemental cash flow information: | | |
| Cash paid for income taxes | \$ 60 | \$ 7 |

See notes to consolidated financial statements.

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BSQUARE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Accounting Policies

Description of Business

BSQUARE Corporation (BSQUARE) was incorporated in Washington State in July 1994. We provide software solutions and related engineering services to companies that develop smart, connected systems. A smart, connected system is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® CE) and is usually connected to a network or data cloud via a wired or wireless connection. Examples of smart, connected systems 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, vending machines and in-vehicle telematics and entertainment devices. We focus on smart, connected systems that utilize Microsoft Windows Embedded and Windows Mobile operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX.

We have been providing software solutions for smart, connected systems since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs) and corporate enterprises (Enterprises), as well as silicon vendors (SVs) and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales. In the case of Enterprises, our customers include those which develop, market and distribute smart, connected systems on their own behalf as well as those that purchase systems from OEMs or ODMs and require additional software, integration and/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.

Basis of Consolidation

The consolidated financial statements include the accounts of BSQUARE Corporation and our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates

Preparing financial statements requires management 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, bonus accruals, fair value of intangible assets and property and equipment, fair values of stock-based awards and the fair values of acquired assets and liabilities, among other estimates. Actual results may differ from these estimates.

Income (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, restricted stock units and warrants. Restricted stock awards (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. Restricted stock units (RSUs) are considered outstanding and included in the computation of basic income or loss per share only when vested. Diluted income 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 method. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive. Unvested but outstanding RSUs and RSAs (which are forfeitable) are included in the diluted income per share calculation. In a period where we are in a net loss position, the diluted loss per share is computed using the basic share count.

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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted income (loss) per share (in thousands):

| | Year Ended December 31, | |
|--|----------------------------|---------------|
| | 2013 | 2012 |
| Weighted average shares outstanding for basic income (loss) per share | 11,174 | 10,945 |
| Dilutive effect of common stock equivalent shares | | 504 |
| Weighted average shares outstanding for diluted income (loss) per share | 11,174 | 11,449 |

Common stock equivalent shares of 990,831 and 1,034,183 were excluded from the computations of basic and diluted income per share for the years ended December 31, 2013 and 2012, respectively, because their effect was anti-dilutive. Unvested but outstanding RSUs and RSAs which are forfeitable are included in the diluted income per share calculation. In a period where we are in a net loss position, the diluted loss per share is computed using the basic share count.

Cash, Cash Equivalents and Investments

We invest our excess cash primarily in highly liquid debt instruments of U.S. government agencies and municipalities, debt instruments issued by foreign government, corporate commercial paper, money market funds, and corporate debt securities. We classify all highly liquid investments with stated maturities of three months or less from date of purchase as cash equivalents and all highly liquid investments with stated maturities of greater than three months as short-term investments.

Short-term investments consist entirely of marketable securities which are all classified as available-for-sale securities and are recorded at their estimated fair value. We determine the appropriate classification of our investments at the time of purchase and reevaluate such designation at each balance sheet date. We may or may not hold securities with stated maturities greater than 12 months until maturity. As we view these securities as available to support current operations, we classify securities with maturities beyond 12 months as short-term investments. We carry these securities at fair value, and report the unrealized gains and losses, net of taxes, as a component of stockholders' equity, except for unrealized losses determined to be other than temporary which are recorded in other expense.

Restricted Cash

Our restricted cash represents funds held at a financial institution as security for an outstanding letter of credit expiring in 2020 related to our corporate headquarters lease obligation.

Financial Instruments and Concentrations of Risk

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, short-term investments, and accounts receivable.

Allowance for Doubtful Accounts

We record accounts receivable at the invoiced amount net of an estimated allowance for doubtful accounts to reserve for potentially uncollectible receivables. We review customers which are past due to identify specific customers with known disputes or collectability issues. In determining the amount of the allowance, we make judgments about the creditworthiness of significant customers based on ongoing credit evaluations.

Equipment, Furniture and Leasehold Improvements

We account for equipment, furniture and leasehold improvements at cost less accumulated depreciation and amortization. We compute depreciation of equipment and furniture using the straight-line method over the estimated useful lives of the assets, generally three years. Leasehold improvements are amortized using the

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straight-line method over the shorter of the lease term or estimated useful lives, ranging from two to ten years. Maintenance and repairs costs are expensed as incurred. When assets are retired or otherwise disposed of, gains or losses are included in the statement of operations. When facts and circumstances indicate that the value of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the asset to projected undiscounted future cash flows. Upon indication that the carrying value of such assets may not be recoverable, we recognize an impairment loss as a charge against current operations based on the difference between the carrying value of the asset and its fair value.

Intangible Assets

Intangible assets were recorded as a result of business acquisitions and are stated at estimated fair value at the time of acquisition less accumulated amortization. We amortize our acquired intangible assets using the straight-line method using lives ranging from one to ten years. We review intangible assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. We measure recoverability of these assets by comparing the carrying amounts to the future undiscounted cash flows the assets are expected to generate. If intangible assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value.

Goodwill

We evaluate goodwill for impairment annually or more frequently when an event occurs or circumstances change that indicate that the carrying value may not be recoverable. We test goodwill for impairment by performing a qualitative assessment to determine whether it is more likely than not that the fair value of the reporting unit is less than the carrying amount. If it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, no further testing is performed. If it is more likely than not that the fair value of the reporting unit is less than the carrying amount, we perform a quantitative two-step impairment test. The first step compares the fair value of the reporting unit with its carrying amount, including goodwill. If the carrying amount exceeds fair value, then the second step of the impairment test is performed to measure the amount of any impairment loss.

Third-Party Software Fees Payable

We record all fees payable and accrued liabilities related to the sale of third-party software, such as Microsoft Windows Embedded and Windows Mobile operating systems, as third-party software fees payable.

Research and Development

Research and development costs are expensed as incurred.

Advertising Costs

All costs of advertising, including cooperative marketing arrangements, are expensed as incurred. Advertising expense was \$501,000 in 2013 and \$733,000 in 2012.

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 of stock based awards 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

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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.

Incentive Compensation

We make certain estimates, judgments and assumptions regarding the likelihood of our 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 our attainment estimate factors estimated future results, 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.

Comprehensive Income (Loss)

Comprehensive income (loss) refers to net income (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 (loss).

Income Taxes

We are subject to income taxes in the U.S. and certain foreign jurisdictions. Significant judgment is required in determining our provision for income taxes. We compute income taxes using the asset and liability method, under which deferred income taxes are provided for on the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities. Our deferred tax amounts are measured using currently enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amounts expected to be realized.

We recognize tax benefits from an uncertain position only if it is more likely than not that the position is sustainable, based on its technical merits. The tax benefit of a qualifying position is the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. Interest and penalties related to uncertain tax positions are classified in the financial statements as income tax expense.

Foreign Currency

The functional currency of foreign subsidiaries is their local currency. Accordingly, assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet. Resulting translation adjustments are included in *Other Comprehensive Income (Loss)* and *Accumulated Other Comprehensive Loss*, a separate component of shareholders' equity. The net gains and losses resulting from foreign currency transactions are recorded in the period incurred and were not significant for any of the periods presented.

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

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and time records are generally used to verify delivery. We assess whether the 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 such engagements before we have received a signed contract.

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. Fixed-price service agreements, and certain time and materials service agreements with capped fee structures, are accounted for using the percentage-of-completion method assuming reasonable estimates of completion can be made. We use the percentage-of-completion method of accounting because we believe it is the most accurate method to recognize revenue based on the nature and scope of these engineering service contracts; we believe 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. Significant judgment is required when estimating total hours and progress to completion on these arrangements which 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, judgment 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.

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 other revenue recognition criteria are met, particularly the criteria that collectability is reasonably assured.

Recently Issued Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a

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Similar Tax Loss, or a Tax Credit Carryforward Exists to bring conformity in the presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. ASU 2013-11 became effective for us on January 1, 2014. We do not believe the adoption of this guidance will have a material impact on our consolidated financial statements or notes to the consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income (AOCI) by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. Our adoption of ASU 2013-02 effective January 1, 2013 did not have any effect on our financial position, results of operations or cash flows.

2. Cash and Investments

Cash, cash equivalents, short-term investments, and restricted cash consist of the following (in thousands):

| | December 31, | |
|---|---------------------|------------------|
| | 2013 | 2012 |
| Cash | \$ 2,521 | \$ 2,590 |
| Cash equivalents money market funds | 10,989 | 7,313 |
| Total cash and cash equivalents | 13,510 | 9,903 |
| Short-term investments: | | |
| Municipal securities | | 356 |
| Corporate commercial paper | 1,500 | 4,374 |
| Foreign government bonds | 1,001 | 999 |
| Corporate debt securities | 4,794 | 4,097 |
| Total short-term investments | 7,295 | 9,826 |
| Restricted cash money market fund | 250 | 875 |
| Total cash, cash equivalents, short-term investments and restricted cash | \$ 21,055 | \$ 20,604 |

Gross unrealized gains and losses on our cash equivalents and short-term investments were not material as of December 31, 2013 and December 31, 2012. Our restricted cash balance at December 31, 2013 and 2012 relates to a letter of credit which secures our corporate headquarters lease.

3. Fair Value Measurements

We measure our cash equivalents, marketable securities and restricted cash 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.

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- 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.

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We classify our cash equivalents, marketable securities and restricted cash within Level 1 or Level 2. This is because we value these items using quoted market prices or alternative pricing sources and models utilizing market observable inputs that are actively quoted and can be validated through external sources, including third-party pricing services, brokers and market transactions. We review the pricing techniques and methodologies of the independent pricing service for Level 2 investments and believe that the policies adequately consider market activity, either based on specific transactions for the security valued or based on modeling of securities with similar credit quality, duration, yield and structure that were recently traded.

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

| | December 31, 2013 | | |
|--|---|---|------------------|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Total |
| Assets: | | | |
| Cash equivalents money market fund | \$ 10,989 | \$ | \$ 10,989 |
| Short-term investments: | | | |
| Corporate commercial paper | | 1,500 | 1,500 |
| Foreign government bonds | | 1,001 | 1,001 |
| Corporate debt securities | | 4,794 | 4,794 |
| Total short-term investments | | 7,295 | 7,295 |
| Restricted cash money market fund | 250 | | 250 |
| Total assets measured at fair value | \$ 11,239 | \$ 7,295 | \$ 18,534 |

| | December 31, 2012 | | |
|--|---|---|------------------|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Total |
| Assets: | | | |
| Cash equivalents money market fund | \$ 7,313 | \$ | \$ 7,313 |
| Short-term investments: | | | |
| Municipal securities | | 356 | 356 |
| Corporate commercial paper | | 4,374 | 4,374 |
| Foreign government bonds | | 999 | 999 |
| Corporate debt securities | | 4,097 | 4,097 |
| Total short-term investments | | 9,826 | 9,826 |
| Restricted cash money market fund | 875 | | 875 |
| Total assets measured at fair value | \$ 8,188 | \$ 9,826 | \$ 18,014 |

Table of Contents**4. Equipment, Furniture and Leasehold Improvements**

Equipment, furniture, and leasehold improvements consist of the following (in thousands):

| | December 31, | |
|--|----------------|----------------|
| | 2013 | 2012 |
| Computer equipment and software | \$ 2,520 | \$ 2,964 |
| Office furniture and equipment | 536 | 1,365 |
| Leasehold improvements | 917 | 958 |
| Total | 3,973 | 5,287 |
| Less: accumulated depreciation and amortization | (3,562) | (4,528) |
| Equipment, furniture and leasehold improvements, net | \$ 411 | \$ 759 |

Depreciation and amortization expense of equipment, furniture and leasehold improvements was \$495,000 in 2013 and \$672,000 in 2012. In 2013, we wrote off approximately \$1.4 million of fully depreciated assets.

5. Goodwill and Intangible Assets

Goodwill was recorded in connection with the September 2011 acquisition of MPC Data, Ltd. (MPC), a United Kingdom based provider of software engineering services. The excess of the acquisition consideration over the fair value of net assets acquired was recorded as goodwill. Bsquare operates as a single reporting unit, and MPC falls within that reporting unit. There was no change in the carrying amount of goodwill for the year ended December 31, 2013.

Intangible assets relate to customer relationships and non-compete agreements that we acquired from TestQuest Inc. in November 2008 and from the acquisition of MPC in September 2011.

Information regarding our intangible assets is as follows (in thousands):

| | December 31, 2013 | | |
|------------------------|-----------------------------|-----------------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Customer relationships | \$ 1,275 | \$ (412) | \$ 863 |
| Non-compete agreements | 196 | (196) | |
| Total | \$ 1,471 | \$ (608) | \$ 863 |

| | December 31, 2012 | | |
|------------------------|-----------------------------|-----------------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Customer relationships | \$ 1,275 | \$ (276) | \$ 999 |
| Non-compete agreements | 196 | (126) | 70 |
| Total | \$ 1,471 | \$ (402) | \$ 1,069 |

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Amortization expense was \$206,000 and \$321,000 for 2013 and 2012, respectively. As of December 31, 2013, expected amortization expense for acquisition-related intangible assets for each of the next five years and thereafter is as follows (in thousands):

| | |
|--------------|---------------|
| 2014 | \$ 135 |
| 2015 | 135 |
| 2016 | 130 |
| 2017 | 98 |
| 2018 | 98 |
| Thereafter | 267 |
| Total | \$ 863 |

6. Other Income, Net

The components of other income, net are as follows (in thousands):

| | Year Ended December 31, | |
|--|----------------------------|---------------|
| | 2013 | 2012 |
| Difference on earn-out paid related to MPC acquisition | \$ | \$ 135 |
| Interest income | 83 | 35 |
| Other | (43) | (67) |
| Total | \$ 40 | \$ 103 |

7. Income Taxes

Income (loss) before income taxes consists of the following (in thousands):

| | Year Ended December 31, | |
|--------------|----------------------------|-----------------|
| | 2013 | 2012 |
| U.S. | \$ (3,084) | \$ 1,687 |
| Foreign | 21 | (405) |
| Total | \$ (3,063) | \$ 1,282 |

Income tax expense consists of the following (in thousands):

| | Year Ended December 31, | |
|----------------|----------------------------|------|
| | 2013 | 2012 |
| Current taxes: | | |
| Federal | \$ | \$ |

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| | | |
|-----------------|----------|--------|
| State and local | (14) | 27 |
| Foreign | 52 | 72 |
| Current taxes | 38 | 99 |
| Deferred taxes: | | |
| Federal | \$ 2,181 | \$ 459 |
| State and local | | |
| Foreign | (25) | (192) |
| Deferred taxes | 2,156 | 267 |
| Total | \$ 2,194 | \$ 366 |

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The components of net deferred tax assets consist of the following (in thousands):

| | December 31, | |
|---|--------------|----------|
| | 2013 | 2012 |
| Net deferred income tax assets: | | |
| Depreciation and amortization | \$ 775 | \$ 917 |
| Accrued expenses and reserves | 2,968 | 1,771 |
| Net operating loss carryforwards | 20,652 | 20,509 |
| Capital loss carryforwards | 290 | 290 |
| Research and development credit carryforwards | 2,673 | 2,535 |
| Stock-based compensation | 487 | 425 |
| | | |
| Gross deferred tax assets | 27,845 | 26,447 |
| | | |
| Less: valuation allowance | (27,673) | (24,102) |
| | | |
| Net deferred tax assets | \$ 172 | \$ 2,345 |

Our net deferred tax assets are recorded as follows (in thousands):

| | December 31, | |
|-----------------------------------|--------------|----------|
| | 2013 | 2012 |
| Net deferred tax assets: | | |
| Deferred tax assets - current | \$ 12 | \$ 296 |
| Deferred tax assets - non-current | 304 | 2,255 |
| Deferred tax liability | (144) | (206) |
| | | |
| Net deferred tax assets | \$ 172 | \$ 2,345 |

As of December 31, 2013, our deferred tax assets were primarily the result of U.S. NOL and tax credit carryforwards. A valuation allowance of \$27.7 million and \$24.1 million was recorded against our gross deferred tax asset balance as of December 31, 2013, and December 31, 2012, respectively. For the year ended December 31, 2013, we recorded an increase in valuation allowance of \$3.6 million on the basis of management's reassessment of the amount of its deferred tax assets that are more likely than not to be realized. As of each reporting date, our management considers new evidence, both positive and negative, that could impact management's view with regard to future realization of deferred tax assets. In the third quarter of 2013, we determined that it was not more likely than not that we would generate sufficient future taxable income to utilize the portion of our net US deferred tax assets, which had been previously recognized, and we increased our valuation allowance in the U.S. by \$2.2 million. Deferred tax assets relative to our foreign tax jurisdictions were not affected.

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The provision for income taxes differs from the amount of expected income tax expense (benefit) determined by applying the applicable U.S. statutory federal income tax rate to pre-tax income (loss), as a result of the following:

| | Year Ended December 31, | |
|-------------------------------------|----------------------------|--------|
| | 2013 | 2012 |
| Taxes at the U.S. statutory rate | 34.0% | 34.0% |
| Increase (decrease) resulting from: | | |
| Tax credits | 4.5 | |
| State income tax | 0.6 | 0.7 |
| International operations | 10.3 | (21.3) |
| Incentive stock options | (0.6) | 1.0 |
| Valuation allowance | (118.0) | (8.3) |
| Expiration of state NOLs | (6.2) | 22.1 |
| Other, net | 3.7 | 0.4 |
| | (71.7)% | 28.6% |

At December 31, 2013, we had approximately \$55.6 million of federal and \$9.3 million of state net operating loss carryforwards, which have begun to expire, including \$3.3 million of state losses in 2013. Of the federal net operating loss carryforwards, an aggregate of \$42.5 million will expire in 2022 and 2023. We also have \$2.7 million of tax credit carryforwards, which begin to expire in 2018. Utilization of these carryforwards may be subject to an annual limitation due to Section 382 of the U.S. Internal Revenue Code which restricts the ability of a corporation that undergoes an ownership change to use its carryforwards. Under the applicable tax rules, an ownership change occurs if holders of more than five percent of an issuer's outstanding common stock, collectively, increase their ownership percentage by more than 50 percentage points over a rolling three-year period. We performed analyses of possible ownership changes, which included consideration of a third party study completed in 2012, and do not believe that an ownership change of more than 50 percentage points has occurred. While the study has not been updated in 2013, we do not believe there have been any further impacts on the results of that analysis in 2013.

We have evaluated all the material income tax positions taken on our income tax filings to various tax authorities, and we determined that we did not have unrealized tax benefits related to uncertain tax positions recorded at December 31, 2013 or 2012.

Because of net operating loss and tax credit carryforwards, substantially all of our tax years remain open and subject to examination.

8. Commitments and Contingencies***Contractual Commitments***

Our commitments include obligations outstanding under operating leases, which expire through 2020. We have lease commitments for office space in Bellevue, Washington; San Diego, California; Boston, Massachusetts; Taipei, Taiwan; Tokyo, Japan; and Trowbridge, UK. We also lease office space on a month-to-month basis in Akron, Ohio.

In August 2013, we amended the lease agreement for our Bellevue, Washington headquarters and extended the term of the original lease that was scheduled to expire in August 2014 to May 2020.

Rent expense was \$1.6 million in 2013 and \$1.8 million in 2012.

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As of December 31, 2013, we had \$250,000 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.

Operating lease commitments at December 31, 2013 are as follows (in thousands):

| | |
|-------|----------|
| 2014 | \$ 1,030 |
| 2015 | 1,128 |
| 2016 | 1,144 |
| 2017 | 1,168 |
| 2018 | 1,142 |
| 2019 | 1,067 |
| 2020 | 449 |
| Total | \$ 7,128 |

Volume Pricing Agreements

In conjunction with our activities under the OEM Distribution Agreements (ODAs) with Microsoft Corporation (Microsoft), we enter into OEM Volume Royalty Pricing (OVRP) commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don't meet the committed minimum unit volumes, we are obligated to pay the difference between the committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather, the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. However, in the event a customer is unwilling or unable to pay us, we would be negatively impacted. Based upon the credit-worthiness of our customers, our historical OVRP experience with our customers and OVRP arrangements in general, we do not believe we will incur any material liability in the current or future periods relating to existing agreements.

9. Shareholders Equity
Equity Compensation Plans

We have a stock plan (the Stock Plan) and an inducement stock plan for newly hired employees (the Inducement Plan) (collectively the Plans). Under the Plans, stock options may be granted with a fixed exercise price that is equivalent to 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 Stock Plan may only be granted to our employees. The Plans also allow for awards of non-qualified stock options, stock appreciation rights, RSAs and unrestricted stock awards, and RSUs.

Table of Contents**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 of stock based awards 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 the Company's 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:

| | Year Ended December 31, | |
|-------------------------|----------------------------|-----------|
| | 2013 | 2012 |
| Dividend yield | 0% | 0% |
| Expected life | 4.2 years | 3.8 years |
| Expected volatility | 61% | 73% |
| Risk-free interest rate | 0.9% | 0.6% |

The impact on our results of operations of recording stock-based compensation expense for the years ended December 31, 2013 and 2012 was as follows (in thousands, except per share amounts):

| | Year Ended December 31, | |
|--|----------------------------|---------|
| | 2013 | 2012 |
| Cost of revenue service | \$ 219 | \$ 315 |
| Selling, general and administrative | 579 | 521 |
| Research and development | 100 | 115 |
| Total stock-based compensation expense | \$ 898 | \$ 951 |
| Per diluted share | \$ 0.08 | \$ 0.08 |

Stock Option Activity

The following table summarizes stock option activity under the Plans for 2013 and 2012:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|------------------------------|---------------------|--|---|---------------------------------|
| Stock Options | | | | |
| Balance at January 1, 2012 | 1,939,475 | \$ 4.49 | 4.33 | |
| Granted at fair value | 244,125 | 3.27 | | |
| Exercised | (90,786) | 2.41 | | |
| Forfeited | (327,422) | 6.67 | | |
| Expired | (225,774) | 7.24 | | |
| Balance at December 31, 2012 | 1,539,618 | \$ 3.55 | 4.24 | |
| Granted at fair value | 328,080 | 3.03 | | |

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| | | | | |
|--|-----------|---------|------|------------|
| Exercised | (31,925) | 2.49 | | |
| Forfeited | (130,131) | 3.23 | | |
| Expired | (190,021) | 4.58 | | |
| Balance at December 31, 2013 | 1,515,621 | \$ 3.36 | 3.93 | \$ 953,186 |
| Vested and expected to vest at December 31, 2013 | 1,466,306 | \$ 3.36 | 3.82 | \$ 932,995 |
| Exercisable at December 31, 2013 | 1,118,271 | \$ 3.34 | 2.73 | \$ 784,434 |

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At December 31, 2013, total compensation cost related to stock options granted to employees under the Plans but not yet recognized was \$296,340, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.3 years. 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 year end. We issue new shares of common stock upon exercise of stock options.

The following table summarizes certain information about stock options for 2013 and 2012:

| | Year Ended December 31, | |
|--|----------------------------|-----------|
| | 2013 | 2012 |
| Weighted average grant-date fair value for options granted during the year | \$ 1.59 | \$ 2.02 |
| Options in-the-money at December 31 | 734,130 | 606,666 |
| Aggregate intrinsic value of options exercised | \$ 24,429 | \$ 73,000 |

Restricted Stock Unit Activity

The following table summarizes restricted stock unit activity under the Stock Plan for 2013 and 2012:

| | Number of Shares | Weighted Average Exercise Price |
|--|---------------------|--|
| | | Price |
| Unvested at December 31, 2012 | 241,248 | \$ 5.91 |
| Granted | 177,592 | 3.49 |
| Vested | (148,743) | 4.98 |
| Forfeited | (33,584) | 6.07 |
| Unvested at December 31, 2013 | 236,513 | \$ 4.95 |
| Granted | 128,838 | 2.75 |
| Vested | (171,404) | 3.82 |
| Forfeited | (6,565) | 6.80 |
| Unvested at December 31, 2013 | 187,382 | \$ 4.40 |
| Expected to vest after December 31, 2013 | 172,790 | \$ 4.23 |

At December 31, 2013, total compensation cost related to restricted stock units granted under the Stock Plan but not yet recognized was \$509,004, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.2 years.

Common Stock Reserved for Future Issuance

The following table summarizes our shares of common stock reserved for future issuance under the Plans at December 31, 2013 and 2012:

| | December 31, | |
|---------------------------|--------------|-----------|
| | 2013 | 2012 |
| Stock options outstanding | 1,515,621 | 1,539,618 |

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| | | |
|---|-----------|-----------|
| Restricted stock units outstanding | 187,382 | 236,513 |
| Stock options available for future grant | 1,024,941 | 1,157,149 |
| Common stock reserved for future issuance | 2,727,944 | 2,933,280 |

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10. Employee Benefit Plan

Profit Sharing and Deferred Compensation Plan

We have a Profit Sharing and Deferred Compensation Plan (Profit Sharing Plan) under Section 401(k) of the Internal Revenue Code of 1986, as amended. Substantially all full-time employees are eligible to participate in the Profit Sharing Plan. We typically elect to match the participants contributions to the Profit Sharing Plan up to a certain amount subject to vesting. Participants will receive their share of the value of their investments, and any applicable vested match, upon retirement or termination. We made matching contributions of \$335,000 in 2013 and \$346,000 in 2012.

11. Significant Risk Concentrations

Significant Customer

No customer accounted for 10% or more of total revenue in 2013 or 2012.

Future Electronics, Inc. had an accounts receivable balance of \$3.7 million, or 23% of total accounts receivable, as of December 31, 2013. Mitsubishi Electric Corporation had an accounts receivable balance of \$2.8 million, or 18% of total accounts receivable, as of December 31, 2013, all of which was subsequently collected. Bluebird Soft, Inc. had an accounts receivable balance of \$2.1 million, or 13% of total accounts receivable, as of December 31, 2012. No other customer accounted for 10% or more of total accounts receivable at December 31, 2013 or 2012.

Significant Supplier

We have ODAs with Microsoft which enable us to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba), Mexico, the European Union and the European Free Trade Association, which expire on June 30, 2014. We also have ODAs with Microsoft which allow us to sell Microsoft Windows Mobile operating systems in the Americas, Japan, Taiwan, Europe, the Middle East, and Africa. Our current distribution agreements related to Windows Mobile expire on June 30, 2014. Our rights to distribute Windows Mobile operating systems in Korea expired on October 31, 2012. We sold \$4.5 million of Windows Mobile operating systems in Korea in 2012.

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 to sell Microsoft Windows Embedded operating systems pursuant to which we earn money for achieving certain predefined objectives. Prior to the third quarter of 2013, the earned rebate amount was treated as a reduction in software cost of sales in the quarter earned. Beginning in the third quarter of 2013, as a result of program modifications, we began treating a portion of the rebate as marketing development funds which are accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

Under this rebate program, we earned \$774,000 in 2013 and \$888,000 in 2012, which was treated as a reduction in cost of sales. Additionally, in 2013, we earned \$409,000 which will be accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

12. Restructuring

During the fourth quarter of 2013, we effected a restructuring that included a workforce reduction and the closure of our offices in Beijing, China and Munich, Germany. The workforce reduction impacted approximately 20% of our worldwide workforce. The restructuring was intended to better align our organizational structure with our strategic focus.

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The staff reductions and office closures were substantially completed by the end of the fourth quarter of 2013 with some activities, including legal entity closures, continuing into 2014.

The total amount expected to be incurred in connection with the restructuring, inclusive of asset impairments, and the amount incurred during the year ended December 31, 2013 by expense type is as follows (in thousands):

| | Total Estimated Expense | Incurred through December 31, 2013 |
|--------------|----------------------------|---------------------------------------|
| Severance | \$ 419 | \$ 419 |
| Other | 142 | 96 |
| Total | \$ 561 | \$ 515 |

A reconciliation of the beginning and ending liability balances by expense type follows (in thousands):

| | Severance Expense | Other Expenses |
|-----------------------------------|----------------------|-------------------|
| Beginning Balance January 1, 2013 | \$ | \$ |
| Costs charged to expense | 419 | 96 |
| Costs paid or otherwise settled | (387) | (96) |
| Ending Balance December 31, 2013 | \$ 32 | \$ |

The foregoing costs are included in the results of operations as follows (in thousands):

| | |
|-------------------------------------|---------------|
| Cost of revenue | \$ 163 |
| Selling, general and administrative | 221 |
| Research and development | 131 |
| Total | \$ 515 |

13. 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, and 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. Revenue by geography are based on the sales region of the customer. The following table sets forth revenue and long-lived assets by geographic area (in thousands):

| | Year Ended December 31, | |
|----------------|----------------------------|-----------|
| | 2013 | 2012 |
| Total revenue: | | |
| North America | \$ 80,412 | \$ 81,581 |

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| | | |
|----------------------|------------------|-------------------|
| Asia | 7,314 | 14,875 |
| Europe | 4,382 | 4,938 |
| Total revenue | \$ 92,108 | \$ 101,394 |

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| | December 31, | |
|--------------------------------|-----------------|-----------------|
| | 2013 | 2012 |
| Long-lived assets: | | |
| North America | \$ 678 | \$ 3,663 |
| Asia | 403 | 447 |
| Europe | 4,544 | 4,703 |
| Total long-lived assets | \$ 5,625 | \$ 8,813 |

14. Quarterly Financial Information (Unaudited)

Following is a summary of unaudited quarterly financial information for 2013 and 2012:

| | Condensed Consolidated Statements of Operations | | | |
|---|---|------------|-----------|-----------|
| | 2013 | | | |
| | Q4 | Q3 | Q2 | Q1 |
| | (in thousands, except per share data) | | | |
| Revenue | \$ 25,829 | \$ 23,572 | \$ 21,837 | \$ 20,870 |
| Gross profit | 4,516 | 3,369 | 3,793 | 3,347 |
| Income (loss) from operations | 25 | (1,395) | (786) | (947) |
| Net loss | \$ (23) | \$ (3,567) | \$ (805) | \$ (862) |
| Basic loss per share | \$ (0.00) | \$ (0.32) | \$ (0.07) | \$ (0.08) |
| Diluted loss per share | \$ (0.00) | \$ (0.32) | \$ (0.07) | \$ (0.08) |
| Shares used in calculation of loss per share: | | | | |
| Basic | 11,246 | 11,194 | 11,149 | 11,107 |
| Diluted | 11,246 | 11,194 | 11,149 | 11,107 |

| | Condensed Consolidated Statements of Operations | | | |
|--|---|-----------|-----------|-----------|
| | 2012 | | | |
| | Q4 | Q3 | Q2 | Q1 |
| | (in thousands, except per share data) | | | |
| Revenue | \$ 25,856 | \$ 25,485 | \$ 24,505 | \$ 25,548 |
| Gross profit | 5,025 | 4,842 | 4,390 | 4,802 |
| Income (loss) from operations | 611 | 1,115 | (270) | (277) |
| Net income (loss) | \$ 696 | \$ 610 | \$ (202) | \$ (188) |
| Basic income (loss) per share | \$ 0.06 | \$ 0.06 | \$ (0.02) | \$ (0.02) |
| Diluted income (loss) per share | \$ 0.06 | \$ 0.05 | \$ (0.02) | \$ (0.02) |
| Shares used in calculation of income (loss) per share: | | | | |
| Basic | 11,058 | 10,943 | 10,922 | 10,875 |
| Diluted | 11,310 | 11,474 | 10,922 | 10,875 |

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| | Condensed Consolidated Balance Sheets | | | |
|--|--|---------------------|----------------|-----------------|
| | 2013 | | | |
| | December 31 | September 30 | June 30 | March 31 |
| | (in thousands) | | | |
| Cash and cash equivalents | \$ 13,510 | \$ 13,236 | \$ 10,771 | \$ 10,177 |
| Accounts receivable, net | 15,893 | 12,811 | 13,614 | 12,639 |
| Total current assets | 39,023 | 35,560 | 35,080 | 33,378 |
| Total assets | 44,648 | 41,309 | 43,517 | 41,978 |
| Third-party software fees payable | 12,746 | 11,055 | 10,090 | 8,712 |
| Accounts payable | 634 | 778 | 510 | 276 |
| Accrued compensation | 2,383 | 1,986 | 2,242 | 1,862 |
| Other accrued expenses | 1,249 | 1,332 | 1,772 | 1,490 |
| Total current liabilities | 19,189 | 16,225 | 15,486 | 13,338 |
| Common stock | 129,423 | 129,215 | 128,991 | 128,730 |
| Accumulated deficit | (103,993) | (103,968) | (100,403) | (99,598) |
| Total shareholders' equity | 24,671 | 24,456 | 27,709 | 28,301 |
| Total liabilities and shareholders' equity | 44,648 | 41,309 | 43,517 | 41,978 |

| | Condensed Consolidated Balance Sheets | | | |
|--|--|---------------------|----------------|-----------------|
| | 2012 | | | |
| | December 31 | September 30 | June 30 | March 31 |
| | (in thousands) | | | |
| Cash and cash equivalents | \$ 9,903 | \$ 6,897 | \$ 10,515 | \$ 7,233 |
| Accounts receivable, net | 16,095 | 16,586 | 15,013 | 17,714 |
| Total current assets | 36,978 | 36,972 | 36,442 | 36,077 |
| Total assets | 45,791 | 45,332 | 45,826 | 45,491 |
| Third-party software fees payable | 11,099 | 10,763 | 10,683 | 10,844 |
| Accounts payable | 553 | 202 | 338 | 766 |
| Accrued compensation | 2,205 | 1,956 | 2,429 | 2,263 |
| Other accrued expenses | 1,732 | 2,490 | 2,666 | 2,022 |
| Total current liabilities | 16,426 | 16,979 | 17,906 | 17,724 |
| Common stock | 128,474 | 128,123 | 128,203 | 127,797 |
| Accumulated deficit | (98,736) | (99,432) | (100,042) | (99,840) |
| Total shareholders' equity | 29,005 | 27,971 | 27,531 | 27,374 |
| Total liabilities and shareholders' equity | 45,791 | 45,332 | 45,826 | 45,491 |

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Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

None.

Item 9A. *Controls and Procedures.*
Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that the information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC'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. In connection with the preparation of this Annual Report on Form 10-K, our management carried out an evaluation, under the supervision and with the participation of our CEO and CFO, as of December 31, 2013, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of December 31, 2013.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of our financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act and includes those policies and procedures that: (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements. All internal controls, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework (1992)*.

Based on its assessment, our management concluded that, as of December 31, 2013, our internal control over financial reporting was effective.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during the fourth quarter of 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. *Other Information.*

None.

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PART III

Item 10. *Directors, Executive Officers and Corporate Governance.*

Certain information required by this Item regarding our directors and executive officers is set forth in Part I of this report under Item 1, Business Directors and Executive Officers of the Registrant and in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the captions Nominees and Other Directors and Executive Officers and is incorporated herein by this reference.

The information required by this Item regarding compliance by our directors, executive officers and holders of ten percent of a registered class of our equity securities with Section 16(a) of the Securities Exchange Act of 1934 is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the caption Section 16(a) Beneficial Ownership Reporting Compliance and is incorporated herein by this reference.

The remaining information required by this Item is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the caption Corporate Governance and is incorporated herein by this reference.

Item 11. *Executive Compensation.*

The information required by this Item is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the captions Corporate Governance and Executive Officer Compensation and is incorporated herein by this reference.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.*

The information required by this Item regarding equity compensation plan information is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the caption Equity Compensation Plan Information and is incorporated herein by this reference.

The information required by this Item regarding security ownership is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the caption Security Ownership of Principal Shareholders, Directors and Management and is incorporated herein by this reference.

Item 13. *Certain Relationships and Related Transactions, and Director Independence.*

The information required by this Item is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the captions Corporate Governance and Certain Relationships and Related Transactions and is incorporated herein by this reference.

Item 14. *Principal Accounting Fees and Services.*

The information required by this Item with respect to principal accounting fees and services is included in our definitive proxy statement for our 2014 annual meeting of shareholders to be filed with the SEC under the caption Independent Auditors and is incorporated herein by this reference.

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PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a) Financial Statements and Schedules

1. *Financial Statements.*

The following consolidated financial statements are filed as part of this report under Item 8 of Part II, Financial Statements and Supplementary Data.

- A. Consolidated Balance Sheets as of December 31, 2013 and 2012.
- B. Consolidated Statements of Operations and Comprehensive Income (Loss) for 2013 and 2012.
- C. Consolidated Statements of Shareholders' Equity for 2013 and 2012.
- D. Consolidated Statements of Cash Flows for 2013 and 2012.

2. *Financial Statement Schedules.*

Financial statement schedules not included herein have been omitted because they are either not required, not applicable, or the information is otherwise included herein.

3. *Exhibits.*

Exhibits are incorporated herein by reference or are filed with this report as indicated below (numbered in accordance with Item 601 of Regulation S-K).

(b) Exhibits

The exhibits listed in the accompanying Index to Exhibits are filed with this report or incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

Date: February 25, 2014

By: /s/ JERRY D. CHASE
Jerry D. Chase

President and Chief Executive Officer

Date: February 25, 2014

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

Senior Vice President, Operations and Chief Financial Officer

POWER OF ATTORNEY

Each person whose individual signature appears below hereby authorizes and appoints Jerry Chase and Scott C. Mahan, and each of them, with full power of substitution and resubstitution and full power to act without the other, as his true and lawful attorney-in-fact and agent to act in his name, place and stead and to execute in the name and on behalf of each person, individually and in each capacity stated below, and to file, any and all amendments to this report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in fact and agents, and each of them, full power and authority to do and perform each and every act and thing, ratifying and confirming all that said attorneys-in-fact and agents or any of them or their or his substitute or substitutes may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on February 25, 2014, on behalf of the registrant and in the capacities indicated.

| Signature | Title |
|---|--|
| /s/ JERRY D. CHASE Jerry Chase | President, Chief Executive Officer and Director (Principal Executive Officer) |
| /s/ SCOTT C. MAHAN Scott C. Mahan | Senior Vice President, Operations and Chief Financial Officer (Principal Financial and Accounting Officer) |
| /s/ ANDREW HARRIES Andrew Harries | Chairman of the Board |
| /s/ ELLIOTT H. JURGENSEN, JR. Elliott H. Jurgensen, Jr. | Director |
| /s/ HAREL KODESH Harel Kodesh | Director |

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/s/ WILLIAM D. SAVOY

Director

William D. Savoy

/s/ KENDRA VANDERMEULEN

Director

Kendra VanderMeulen

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

| Exhibit Number | Description | Filed Herewith | Form | Incorporated by Reference | | |
|----------------|--|----------------|------|---------------------------|----------|-----------|
| | | | | Filing Date | Exhibit | File No. |
| 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 |
| 10.1(1) | Fourth Amended and Restated Stock Plan | | 10-Q | 8/9/2012 | 10.19 | 000-27687 |
| 10.1(a)(1) | Form of Stock Option Agreement | | 10-Q | 8/9/2012 | 10.19(a) | 000-27687 |
| 10.1(b)(1) | Form of Restricted Stock Grant Agreement | | 10-Q | 8/9/2012 | 10.19(b) | 000-27687 |
| 10.1(c)(1) | Form of Restricted Stock Unit Agreement | | 10-Q | 8/9/2012 | 10.19(c) | 000-27687 |
| 10.2(1) | 2011 Inducement Award Plan | | 10-Q | 11/10/2011 | 10.1 | 000-27687 |
| 10.2(a)(1) | Form of Non-Qualified Stock Option Agreement under the 2011 Inducement Award Plan | | 10-Q | 11/10/2011 | 10.1(a) | 000-27687 |
| 10.3(1) | Form of Indemnification Agreement | | S-1 | 8/17/1999 | 10.4 | 333-85351 |
| 10.4 | Office Lease Agreement between WA 110 Atrium Place, L.L.C. and BSQUARE Corporation | | 10-K | 3/30/2004 | 10.19 | 000-27687 |
| 10.4(a) | First Amendment to Office Lease with Talon Portfolio Services LLC dated August 26, 2013 and effective June 1, 2013 | | 8-K | 8/30/2013 | 10.1 | 000-27687 |
| 10.5(1) | Employment Letter Agreement with Scott Mahan | | 10-K | 3/30/2004 | 10.20 | 000-27687 |
| 10.5(a)(1) | Amendment to Employment Letter Agreement with Scott Mahan, dated December 19, 2012 | | 10-K | 2/22/2013 | 10.7(a) | 000-27687 |
| 10.5(b)(1) | Letter Agreement with Scott Mahan amending Employment Letter Agreement, dated August 7, 2013 | | 10-Q | 11/12/2013 | 10.7(b) | 000-27687 |
| 10.6 (1) | Employment Letter Agreement with Brian Crowley | | 10-Q | 5/12/2005 | 10.23 | 000-27687 |
| 10.6(a)(1) | Amendment to Employment Letter Agreement with Brian Crowley, dated December 19, 2012 | | 10-K | 2/22/2013 | 10.8(a) | 000-27687 |
| 10.6(b)(1) | Separation and Release Agreement with Brian Crowley dated September 23, 2013 | | 10-Q | 11/12/2013 | 10.8(b) | 000-27687 |
| 10.6(c)(1) | Individual Contractor Services Agreement with Brian Crowley dated September 23, 2013 | | 10-Q | 11/12/2013 | 10.8(c) | 000-27687 |

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| Exhibit Number | Description | Filed Herewith | Incorporated by Reference | | | |
|-------------------|---|-------------------|---------------------------|-------------|----------|-----------|
| | | | Form | Filing Date | Exhibit | File No. |
| 10.7(1) | Employment Letter Agreement with Mark Whiteside dated effective May 1, 2011 | | 10-Q | 11/12/2013 | 10.13 | 000-27687 |
| 10.7(a)(1) | First Amendment to Employment Letter Agreement with Mark Whiteside dated December 19, 2012 | | 10-Q | 11/12/2013 | 10.13(a) | 000-27687 |
| 10.7(b)(1) | Letter Agreement with Mark Whiteside amending Employment Letter Agreement, dated August 7, 2013 | | 10-Q | 11/12/2013 | 10.13(b) | 000-27687 |
| 10.8(1) | Individual Contractor Services Agreement by and between the Company and Jerry Chase dated September 23, 2013 | | 10-Q | 11/12/2013 | 10.14 | 000-27687 |
| 10.9(2) | Microsoft OEM Distribution Agreement for Software Products for Embedded Systems with Microsoft Licensing, GP effective July 1, 2012 | | 10-Q | 8/9/2012 | 10.12 | 000-27687 |
| 10.10(2) | Microsoft Master Vendor Agreement with Microsoft Corporation effective June 6, 2008 | | 10-Q | 5/10/2012 | 10.18 | 000-27687 |
| 10.10(a)(2) | Statement of Work to Microsoft Master Vendor Agreement, effective January 16, 2012 | | 10-Q | 5/10/2012 | 10.18(a) | 000-27687 |
| 10.10(b)(2) | Statement of Work under the Microsoft Master Vendor Agreement, effective July 1, 2012 | | 10-Q | 8/9/2012 | 10.18(b) | 000-27687 |
| 10.11(2) | Share Purchase Agreement among BSQUARE Corporation and certain shareholders of MPC Data Limited dated September 11, 2011 | | 8-K | 9/13/2011 | 10.1 | 000-27687 |
| 21.1 | Subsidiaries of the registrant | X | | | | |
| 23.1 | Consent of Independent Registered Public Accounting Firm | X | | | | |
| 31.1 | Certification of Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a) under the Securities and Exchange Act of 1934 | X | | | | |
| 31.2 | Certification of Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a) under the Securities and 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 | | | | |

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| Exhibit Number | Description | Filed Herewith | Form | Incorporated by Reference | | |
|-------------------|---|-------------------|------|---------------------------|---------|----------|
| | | | | Filing Date | Exhibit | File No. |
| 101.INS | XBRL Instance Document | X | | | | |
| 101.SCH | XBRL Taxonomy Extension Schema Document | X | | | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | X | | | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase | | | | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | X | | | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | X | | | | |

- (1) Indicates a management contract or compensatory plan or arrangement.
(2) Confidential treatment has previously been granted by the SEC for certain portions of the referenced exhibit.