

BSQUARE CORP /WA  
Form 10-Q  
November 13, 2014  
I

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

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                                  | 91-1650880          |
| (State or other jurisdiction of             | (I.R.S. Employer    |
| incorporation or organization)              | Identification No.) |
| 110 110 <sup>th</sup> Avenue NE, Suite 300, |                     |
| Bellevue WA                                 | 98004               |
| (Address of principal executive offices)    | (Zip Code)          |

(425) 519-5900

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(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) 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 number of shares of common stock outstanding as of October 31, 2014: 11,725,716

BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended September 30, 2014

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## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements  
BSQUARE CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

|  | September<br>30,<br><br>2014<br>(Unaudited) | December 31,<br><br>2013 |
|--|---|--------------------------|
| <b>ASSETS</b>  |   |                          |
| Current assets:  |   |                          |
| Cash and cash equivalents  | \$ 12,575                                   | \$ 13,510                |
| Short-term investments   | 12,646                                      | 7,295                    |
| Accounts receivable, net of allowance for doubtful<br>accounts of \$214 at September 30, 2014<br>and December 31, 2013 | 11,749                                      | 15,893                   |
| Prepaid expenses and other current assets  | 457   | 2,325                    |
| Total current assets   | 37,427                                      | 39,023                   |
| Equipment, furniture and leasehold improvements, net   | 1,405                                       | 411                      |
| Restricted cash  | 250   | 250                      |
| Deferred income taxes  | 304   | 304                      |
| Intangible assets, net   | 762   | 863                      |
| Goodwill   | 3,738                                       | 3,738                    |
| Other non-current assets   | 56  | 59                       |
| Total assets   | \$ 43,942                                   | \$ 44,648                |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |   |                          |
| Current liabilities:   |   |                          |
| Third-party software fees payable  | \$ 9,941                                    | \$ 12,746                |
| Accounts payable   | 171   | 634                      |
| Accrued compensation   | 1,843                                       | 2,383                    |
| Other accrued expenses   | 1,607                                       | 1,249                    |
| Deferred revenue   | 1,504                                       | 2,177                    |
| Total current liabilities  | 15,066                                      | 19,189                   |
| Deferred income taxes  | 144   | 144                      |
| Deferred rent  | 1,792                                       | 644                      |
| Shareholders' equity:  |   |                          |
| Preferred stock, no par value: 10,000,000 shares<br>authorized; no shares issued and outstanding                       | —   | —                        |
| Common stock, no par value: 37,500,000 shares  | 130,709                                     | 129,423                  |

authorized; 11,722,591 shares issued and  
 outstanding at September 30, 2014 and 11,294,682  
 shares issued and outstanding at December 31,  
 2013

|  |            |            |
|--|------------|------------|
| Accumulated other comprehensive loss       | (725 )     | (759 )     |
| Accumulated deficit                        | (103,044 ) | (103,993 ) |
| Total shareholders' equity                 | 26,940     | 24,671     |
| Total liabilities and shareholders' equity | \$ 43,942  | \$ 44,648  |

See notes to condensed consolidated financial statements.

## BSQUARE CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

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

|  | Three Months<br>Ended |            | Nine Months<br>Ended  |            |
|--|-----------------------|------------|-----------------------|------------|
|  | September 30,<br>2014 | 2013       | September 30,<br>2014 | 2013       |
| Revenue:   |                       |            |                       |            |
| Software   | \$19,768              | \$18,456   | \$55,631              | \$51,818   |
| Service  | 4,767                 | 5,116      | 14,690                | 14,461     |
| Total revenue  | 24,535                | 23,572     | 70,321                | 66,279     |
| Cost of revenue:   |                       |            |                       |            |
| Software   | 16,760                | 15,965     | 47,189                | 43,087     |
| Service  | 3,812                 | 4,238      | 11,369                | 12,683     |
| Total cost of revenue                                    | 20,572                | 20,203     | 58,558                | 55,770     |
| Gross profit   | 3,963                 | 3,369      | 11,763                | 10,509     |
| Operating expenses:                                      |                       |            |                       |            |
| Selling, general and administrative                      | 2,880                 | 3,960      | 9,352                 | 11,432     |
| Research and development                                 | 360                   | 804        | 1,215                 | 2,205      |
| Total operating expenses                                 | 3,240                 | 4,764      | 10,567                | 13,637     |
| Income (loss) from operations                            | 723                   | (1,395 )   | 1,196                 | (3,128 )   |
| Other income (expense), net                              | (16 )                 | (15 )      | (118 )                | 100        |
| Income (loss) before income taxes                        | 707                   | (1,410 )   | 1,078                 | (3,028 )   |
| Income tax expense                                       | (16 )                 | (2,157 )   | (129 )                | (2,206 )   |
| Net income (loss)  | \$691                 | \$(3,567 ) | \$949                 | \$(5,234 ) |
| Basic income (loss) per share                            | \$0.06                | \$(0.32 )  | \$0.08                | \$(0.47 )  |
| Diluted income (loss) per share                          | \$0.06                | \$(0.32 )  | \$0.08                | \$(0.47 )  |
| Shares used in calculation of income (loss) per share:   |                       |            |                       |            |
| Basic  | 11,655                | 11,194     | 11,520                | 11,150     |
| Diluted  | 11,832                | 11,194     | 11,732                | 11,150     |
| Comprehensive income (loss):                             |                       |            |                       |            |
| Net income (loss)  | \$691                 | \$(3,567 ) | \$949                 | \$(5,234 ) |
| Other comprehensive income (expense):                    |                       |            |                       |            |
| Foreign currency translation, net of tax                 | (97 )                 | 56         | 34                    | (35 )      |
| Change in unrealized gains on investments, net<br>of tax | —                     | 1          | —                     | (2 )       |
| Total other comprehensive income (expense)               | (97 )                 | 57         | 34                    | (37 )      |
| Comprehensive income (loss)                              | \$594                 | \$(3,510 ) | \$983                 | \$(5,271 ) |

See notes to condensed consolidated financial statements.

## BSQUARE CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

|  | Nine Months<br>Ended  |            |
|--|-----------------------|------------|
|  | September 30,<br>2014 | 2013       |
| <b>Cash flows from operating activities:</b>         |                       |            |
| Net income (loss)                                    | \$949                 | \$(5,234 ) |
| Adjustments to reconcile net income (loss) to net    |                       |            |
| cash provided by operating activities:               |                       |            |
| Realized loss on disposal of assets                  | 33                    | —          |
| Depreciation and amortization                        | 479                   | 586        |
| Stock-based compensation                             | 691                   | 726        |
| Deferred income taxes                                | —                     | 2,181      |
| Changes in operating assets and liabilities:         |                       |            |
| Accounts receivable, net                             | 4,144                 | 3,284      |
| Prepaid expenses and other assets                    | 1,871                 | (418 )     |
| Third-party software fees payable                    | (2,805 )              | (44 )      |
| Accounts payable and accrued expenses                | (645 )                | (394 )     |
| Deferred revenue                                     | (673 )                | 237        |
| Deferred rent  | 20                    | 268        |
| Net cash provided by operating activities            | 4,064                 | 1,192      |
| Cash flows from investing activities:                |                       |            |
| Purchases of equipment and furniture                 | (276 )                | (216 )     |
| Proceeds from maturities of short-term investments   | 9,195                 | 8,932      |
| Purchases of short-term investments                  | (14,547)              | (7,163 )   |
| Reduction of restricted cash                         | —                     | 625        |
| Net cash provided by (used in) investing             |                       |            |
| activities   | (5,628 )              | 2,178      |
| Cash flows provided by financing activities—proceeds |                       |            |
| from exercise of stock options                       | 595                   | 12         |
| Effect of exchange rate changes on cash              | 34                    | (49 )      |
| Net increase (decrease) in cash and cash             |                       |            |
| equivalents  | (935 )                | 3,333      |
| Cash and cash equivalents, beginning of period       | 13,510                | 9,903      |
| Cash and cash equivalents, end of period             | \$12,575              | \$13,236   |
|  | Nine Months<br>Ended  |            |



|  | September 30, |      |
|--|---------------|------|
|  | 2014          | 2013 |
| Supplemental disclosure of cash flow information:  |               |      |
| Non-cash investing activity-leasehold improvements |               |      |
| & furniture funded by landlord                     | \$1,128       | \$—  |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of BSQUARE Corporation (“BSQUARE”) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting and include the accounts of BSQUARE and our wholly owned subsidiaries. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of September 30, 2014 and our operating results and cash flows for the three and nine months ended September 30, 2014 and 2013. The accompanying financial information as of December 31, 2013 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2013. All intercompany balances have been eliminated.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued an Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers”, amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The guidance is effective for annual and interim reporting periods beginning after December 15, 2016, with early adoption prohibited. We are currently evaluating the impact this ASU will have on our consolidated financial statements.

In August 2014 the FASB issued ASU No. 2014-15, Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern, requiring management to evaluate whether there is a substantial doubt about an entity’s ability to continue as a going concern and to provide related disclosures in the notes to the financial statements. The new guidance reduces diversity in the timing and content of disclosures from current guidance, and is effective for annual and interim reporting periods beginning after December 15, 2015 with early adoption permitted. We do not expect the adoption of this guidance to have a material effect on our consolidated financial statements.

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 and restricted stock units. 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.

We excluded an aggregate of 882,490 and 868,767 options and RSUs for the three and nine months ended September 30, 2014, respectively, from diluted earnings per share because their effect was anti-dilutive. We excluded an aggregate of 940,812 and 837,812 options and RSUs for the three and nine months ended September 30, 2013, respectively, from diluted earnings per share because their effect was anti-dilutive. In a period where we are in a net loss position, diluted loss per share is computed using the basic share count.

## 2. Cash and Investments

Cash, cash equivalents, short-term investments, and restricted cash consisted of the following at September 30, 2014 and December 31, 2013 (in thousands):

|  | September<br>30,<br>2014 | December<br>31,<br>2013 |
|--|--------------------------|-------------------------|
| Cash   | \$ 2,718                 | \$ 2,521                |
| Cash equivalents:  |                          |                         |
| Money market funds   | 8,356                    | 8,989                   |
| Corporate commercial paper                                       | 1,250                    | —                       |
| Corporate debt securities  | 251                      | 2,000                   |
| Total cash equivalents   | 9,857                    | 10,989                  |
| Total cash and cash equivalents                                  | 12,575                   | 13,510                  |
| Short-term investments:  |                          |                         |
| Corporate commercial paper                                       | 1,199                    | 1,500                   |
| Foreign government bonds   | —                        | 1,001                   |
| Corporate debt securities  | 11,447                   | 4,794                   |
| Total short-term investments                                     | 12,646                   | 7,295                   |
| Restricted cash—money market fund                                | 250                      | 250                     |
| Total cash, cash equivalents, investments and<br>restricted cash | \$ 25,471                | \$ 21,055               |

Gross unrealized gains and losses on our short-term investments were not material as of September 30, 2014 and December 31, 2013. Our restricted cash balance at September 30, 2014 and December 31, 2013 relates to a letter of credit which secures our corporate headquarters lease.

## 3. Fair Value Measurements

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

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Directly or indirectly observable market-based inputs or unobservable inputs used in models or other valuation methodologies.

Level 3: Unobservable inputs that are not corroborated by market data. The inputs require significant management judgment or estimation.

We classify our cash equivalents and short-term investments within Level 1 or Level 2 because our cash equivalents and short-term investments are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs.



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Assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013 are summarized below (in thousands):

|                                     | September 30, 2014   |                     |          |
|-------------------------------------|--|---------------------|----------|
|                                     | Quoted<br>Prices<br>in   |                     |          |
|                                     | Active<br>Markets<br>for Direct or<br>Indirect<br>Identical<br>Assets Observable |                     |          |
|                                     | (Level<br>1)   | Inputs<br>(Level 2) | Total    |
| <b>Assets</b>                       |  |                     |          |
| Cash equivalents:                   |  |                     |          |
| Money market funds                  | \$8,356  | \$ —                | \$8,356  |
| Corporate commercial paper          | —  | 1,250               | 1,250    |
| Corporate debt                      | —  | 251                 | 251      |
| Total cash equivalents              | 8,356  | 1,501               | 9,857    |
| Short-term investments:             |  |                     |          |
| Corporate commercial paper          | —  | 1,199               | 1,199    |
| Corporate debt                      | —  | 11,447              | 11,447   |
| Total short-term investments        | —  | 12,646              | 12,646   |
| Restricted cash—money market fund   | 250  | —                   | 250      |
| Total assets measured at fair value | \$8,606  | \$ 14,147           | \$22,753 |

|                   | December 31, 2013  |                     |       |
|-------------------|--|---------------------|-------|
|                   | Quoted<br>Prices<br>in   |                     |       |
|                   | Active<br>Markets<br>for Direct or<br>Indirect<br>Identical<br>Assets Observable |                     |       |
|                   | (Level<br>1)   | Inputs<br>(Level 2) | Total |
| <b>Assets</b>     |  |                     |       |
| Cash equivalents: |  |                     |       |

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|                                     |         |          |          |
|-------------------------------------|---------|----------|----------|
| Money market funds                  | \$8,989 | \$ —     | \$8,989  |
| Corporate debt                      | —       | 2,000    | 2,000    |
| Total cash equivalents              | 8,989   | 2,000    | 10,989   |
| Short-term investments:             |         |          |          |
| Corporate commercial paper          | —       | 1,500    | 1,500    |
| Foreign government bonds            | —       | 1,001    | 1,001    |
| Corporate debt                      | —       | 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 | \$9,239 | \$ 9,295 | \$18,534 |

#### 4. Goodwill and Intangible Assets

Goodwill relates to the 2011 acquisition of MPC Data, Ltd. (“MPC”), a United Kingdom based provider of embedded software engineering services. The excess of the acquisition consideration over the fair value of net assets acquired was recorded as goodwill. We operate as a single reporting unit, and MPC falls within that reporting unit. There was no change in the carrying amount of goodwill during the nine months ended September 30, 2014.

Intangible assets relate to customer relationships that we acquired from TestQuest Inc. in 2008 and from the acquisition of MPC in 2011, the vast majority of which relates to the MPC acquisition.

Information regarding our intangible assets as of September 30, 2014 and December 31, 2013 is as follows (in thousands):

|                        | September 30, 2014 |              |          |
|------------------------|--------------------|--------------|----------|
|                        | Gross              |              | Net      |
|                        | Carrying           | Accumulated  | Carrying |
|                        | Amount             | Amortization | Value    |
| Customer relationships | 1,275              | (513 )       | 762      |

|                        | December 31, 2013 |              |          |
|------------------------|-------------------|--------------|----------|
|                        | Gross             |              | Net      |
|                        | Carrying          | Accumulated  | Carrying |
|                        | Amount            | Amortization | Value    |
| Customer relationships | 1,275             | (412 )       | 863      |

Amortization expense was \$34,000 and \$101,000 for the three and nine months ended September 30, 2014, respectively, and \$56,000 and \$172,000 for the three and nine months ended September 30, 2013, respectively. Amortization in future periods is expected to be as follows (in thousands):

|                   |       |
|-------------------|-------|
| Remainder of 2014 | \$34  |
| 2015              | 135   |
| 2016              | 130   |
| 2017              | 98    |
| 2018              | 98    |
| Thereafter        | 267   |
| Total             | \$762 |

## 5. 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.

### Stock-Based Compensation



The estimated fair value of stock-based awards is recognized as compensation expense over the vesting period of the award, net of estimated forfeitures. We estimate forfeitures based on historical experience and expected future activity. The fair value of RSAs and RSUs 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 is 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 stock option grants were estimated with the following weighted average assumptions:

|                         | Three<br>Months<br>Ended |       | September<br>30,<br>2014 |       | September<br>30,<br>2013 |       | Nine Months<br>Ended |       |
|-------------------------|--------------------------|-------|--------------------------|-------|--------------------------|-------|----------------------|-------|
|                         | 2014                     | 2013  | 2014                     | 2013  | 2014                     | 2013  | 2014                 | 2013  |
| Dividend yield          | 0 %                      | 0 %   | 0 %                      | 0 %   | 0 %                      | 0 %   | 0 %                  | 0 %   |
| Expected life           | 3.3                      | 4     | 3.3                      | 4     | years                    | years | years                | years |
| Expected volatility     | 57 %                     | 58 %  | 59 %                     | 62 %  |                          |       |                      |       |
| Risk-free interest rate | 1.4%                     | 1.1 % | 1.3%                     | 0.8 % |                          |       |                      |       |

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The impact on our results of operations of stock-based compensation expense for the three and nine months ended September 30, 2014 and 2013 was as follows (in thousands, except per share amounts):

|  | Three<br>Months<br>Ended |        | Nine Months<br>Ended |        |
|--|--------------------------|--------|----------------------|--------|
|  | September<br>30,         |        | September<br>30,     |        |
|  | 2014                     | 2013   | 2014                 | 2013   |
| Cost of revenue — service              | \$69                     | \$48   | \$146                | \$184  |
| Selling, general and administrative    | 144                      | 145    | 510                  | 456    |
| Research and development               | 15                       | 27     | 35                   | 86     |
| Total stock-based compensation expense | \$228                    | \$220  | \$691                | \$726  |
| Per diluted share                      | \$0.02                   | \$0.02 | \$0.06               | \$0.07 |

Stock Option Activity

The following table summarizes stock option activity under the Plans for the nine months ended September 30, 2014:

|   |            | Weighted<br>Average |             |            |
|---|------------|---------------------|-------------|------------|
|   |            | Weighted            | Remaining   |            |
|   |            | Average             | Contractual | Aggregate  |
|   | Number of  | Exercise            | Life        | Intrinsic  |
| Stock Options                                     | Shares     | Price               | (in years)  | Value      |
| Balance at January 1, 2014                        | 1,515,621  | \$ 3.36             |             |            |
| Granted   | 740,458    | 3.48                |             |            |
| Exercised   | (374,565 ) | 2.49                |             |            |
| Forfeited   | (96,531 )  | 3.27                |             |            |
| Expired   | (258,671 ) | 4.34                |             |            |
| Balance at September 30, 2014                     | 1,526,312  | \$ 3.48             | 6.91        | \$ 954,646 |
| Vested and expected to vest at September 30, 2014 | 1,407,188  | \$ 3.48             | 6.73        | \$ 900,866 |
| Exercisable at September 30, 2014                 | 593,423    | \$ 3.50             | 3.90        | \$ 498,217 |

At September 30, 2014, total compensation cost related to stock options granted but not yet recognized was \$923,055, 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 following table summarizes certain information about stock options for the three and nine months ended September 30, 2014 and 2013:

|  | Three Months Ended |         | Nine Months Ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30,      |         | September 30,     |         |
|  | 2014               | 2013    | 2014              | 2013    |
| Weighted-average grant-date fair value of option |                    |         |                   |         |
| grants for the period                            | \$1.74             | \$—     | \$1.71            | 1.07    |
| Options in-the-money at period end               | 425,877            | 541,000 | 425,877           | 541,000 |
| Aggregate intrinsic value of options exercised   | \$171,558          | \$—     | \$412,781         | \$1,000 |

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

## Restricted Stock Unit Activity

The following table summarizes RSU activity for the nine months ended September 30, 2014:

|   | Number<br>of<br>Shares | Weighted<br>Average<br>Grant<br>Date Fair<br>Value |
|---|------------------------|--|
| Unvested at December 31, 2013             | 187,382                | \$ 4.40  |
| Granted                                   | 102,735                | 3.16   |
| Vested                                    | (132,421)              | 3.70   |
| Forfeited                                 | (56,732 )              | 5.54   |
| Unvested at September 30, 2014            | 100,964                | \$ 3.43  |
| Expected to vest after September 30, 2014 | 96,371                 | \$ 3.37  |

At September 30, 2014, total compensation cost related to RSUs granted but not yet recognized was \$403,482, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.1 years. There were no RSAs outstanding as of September 30, 2014 or December 31, 2013.

## Common Stock Reserved for Future Issuance

The following table summarizes our shares of common stock reserved for future issuance under the Plans:

|   | September<br>30,<br>2014 |
|---|--------------------------|
| Stock options outstanding                 | 1,526,312                |
| Restricted stock units outstanding        | 100,964                  |
| Stock awards available for future grant   | 706,053                  |
| Common stock reserved for future issuance | 2,333,329                |

## 6. Commitments and Contingencies

## Lease and rent obligations

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, which was initially scheduled to expire in August 2014, and extended the lease term to May 2020. The amendment to the headquarters lease provided that no cash lease payments were to be made for a seven-month period from June 1, 2013 to December 31, 2013. In conjunction with the amended lease agreement, the landlord provided lease incentives totaling \$1,128,000 for leasehold improvements and furniture related to new space in the same building, which were capitalized and are reflected in the deferred rent liability. We are amortizing these assets over the shorter of their economic life or the lease term. We are recognizing rent expense, including the effect of the deferred rent, on a straight-line basis over the lease term.

Rent expense was \$281,000 and \$918,000 for the three and nine months ended September 30, 2014, respectively, and \$402,000 and \$1,156,000 for the three and nine months ended September 30, 2013, respectively.

As of September 30, 2014, 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 classified as restricted cash.

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

|                   |         |
|-------------------|---------|
| Remainder of 2014 | \$301   |
| 2015              | 1,290   |
| 2016              | 1,304   |
| 2017              | 1,200   |
| 2018              | 1,111   |
| 2019              | 1,038   |
| 2020              | 437     |
| Total commitments | \$6,681 |

#### Loss Contingencies

From time to time, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business including tax assessments. We defend ourselves vigorously against any such claims. When (i) it is probable that an asset has been impaired or a liability has been incurred and (ii) the amount of the loss can be reasonably estimated, we record the estimated loss. We provide disclosure in the notes to the consolidated financial statements for loss contingencies that do not meet both of these conditions if there is a reasonable possibility that a loss may have been incurred that would be material to the financial statements. Significant judgment is required to determine the probability that a liability has been incurred and whether such liability is reasonably estimable. We base accruals made on the best information available at the time which can be highly subjective. The final outcome of these matters could vary significantly from the amounts included in the accompanying consolidated financial statements.

#### Volume Pricing Agreements

In conjunction with our activities under our OEM Distribution Agreements (“ODAs”) with Microsoft Corporation (“Microsoft”), as further described in Note 8, 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 significant 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 relating to active agreements and, therefore, no provision or reserve has been recorded as of September 30, 2014.

#### 7. Information about Geographic Areas

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

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

|                | Three Months<br>Ended |          | Nine Months<br>Ended |          |
|----------------|-----------------------|----------|----------------------|----------|
|                | September 30,         |          | September 30,        |          |
|                | 2014                  | 2013     | 2014                 | 2013     |
| Total revenue: |                       |          |                      |          |
| North America  | \$22,456              | \$20,875 | \$62,955             | \$59,714 |
| Asia           | 830                   | 1,379    | 3,581                | 3,129    |
| Europe         | 1,249                 | 1,318    | 3,785                | 3,436    |
| Total revenue  | \$24,535              | \$23,572 | \$70,321             | \$66,279 |

|                         | September<br>30, | December<br>31, |
|-------------------------|------------------|-----------------|
|                         | 2014             | 2013            |
| Long-lived assets:      |                  |                 |
| North America           | \$ 1,669         | \$ 678          |
| Asia                    | 365              | 403             |
| Europe                  | 4,480            | 4,544           |
| Total long-lived assets | \$ 6,514         | \$ 5,625        |

## 8. Significant Risk Concentrations

### Significant Customer

One customer, Future Electronics, Inc., accounted for 18% and 11% of total revenue for the three and nine months ended September 30, 2014, respectively. No other customers accounted for more than 10% of total revenue for the three or nine months ended September 30, 2014 or September 30, 2013.

No customer had an accounts receivable balance which was 10% or more of the total accounts receivable at September 30, 2014. Future Electronics, Inc. had an accounts receivable balance of \$3.7 million, or 23% of total accounts receivable, as of December 31, 2013, all of which was subsequently collected, and 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. No other customer accounted for 10% or more of total accounts receivable at December 31, 2013.

### Significant Supplier

We have two ODAs with Microsoft which enable us to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, Argentina, Brazil, Chile, Columbia, Mexico, Peru, Puerto Rico, the Caribbean, the European Union, the European Free Trade Association, Turkey and Africa, which expire on June 30, 2016. We also have four ODAs with Microsoft which allow us to sell Microsoft Windows Mobile operating systems in the Americas (excluding Cuba), Japan, Taiwan, Europe, the Middle East, and Africa, which expire on June 30, 2015.

Software sales under these agreements constitute a significant portion of our software revenue and total revenue. These agreements are typically renewed bi-annually, 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 entire 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 recognized \$64,000 and \$233,000 during the three and nine months ended September 30, 2014, respectively, and \$89,000 and \$658,000 during the three and nine months ended



September 30, 2013, respectively, which was treated as a reduction in cost of sales. Additionally, during the three and nine months ended September 30, 2014, we qualified for \$149,000 and \$543,000, respectively, in rebate credits which will be accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

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

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our condensed consolidated financial statements and related notes. Some statements and information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In some cases, readers can identify forward-looking statements by terms such as "may," "will," "should," "expect," "plan," "intend," "forecast," "anticipate," "believe," "estimate," "predict," "potential," "continue," or the negative of or other comparable terminology, 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 discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2013 entitled "Risk Factors," similar discussions in subsequently filed Quarterly Reports on Form 10-Q, including this Form 10-Q, as applicable, and those contained from time to time in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

### Overview

We provide software solutions to companies that develop smart, connected 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. A smart, connected system also includes the applications and other software that run on or connects to the device. 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 and in-vehicle telematics and entertainment devices. We focus on smart, connected systems that run various Microsoft Windows Embedded and Windows Mobile operating systems, specifically Windows Embedded Compact, Windows Embedded Standard 7 and 8, Windows Mobile™, Windows Phone 8 and Windows Embedded 8 Handheld as well as devices running other popular operating systems such as Android, Linux, and QNX.

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

### Critical Accounting Judgments

Management's discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally

accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales, cost of sales and expenses and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There have been no significant changes to our critical accounting judgments, policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2013.

## 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.

|                                     | Three<br>Months           |        | Nine Months               |       |
|-------------------------------------|---------------------------|--------|---------------------------|-------|
|                                     | Ended<br>September<br>30, |        | Ended<br>September<br>30, |       |
|                                     | 2014                      | 2013   | 2014                      | 2013  |
|                                     | (unaudited)               |        | (unaudited)               |       |
| Revenue:                            |                           |        |                           |       |
| Software                            | 81 %                      | 78 %   | 79 %                      | 78 %  |
| Service                             | 19 %                      | 22 %   | 21 %                      | 22 %  |
| Total revenue                       | 100%                      | 100 %  | 100%                      | 100 % |
| Cost of revenue:                    |                           |        |                           |       |
| Software                            | 68 %                      | 68 %   | 67 %                      | 65 %  |
| Service                             | 16 %                      | 18 %   | 16 %                      | 19 %  |
| Total cost of revenue               | 84 %                      | 86 %   | 83 %                      | 84 %  |
| Gross profit                        | 16 %                      | 14 %   | 17 %                      | 16 %  |
| Operating expenses:                 |                           |        |                           |       |
| Selling, general and administrative | 12 %                      | 17 %   | 13 %                      | 18 %  |
| Research and development            | 1 %                       | 3 %    | 2 %                       | 3 %   |
| Total operating expenses            | 13 %                      | 20 %   | 15 %                      | 21 %  |
| Income (loss) from operations       | 3 %                       | (6 )%  | 2 %                       | (5 )% |
| Other income (expense), net         | 0 %                       | 0 %    | (1 )%                     | 0 %   |
| Income (loss) before income taxes   | 3 %                       | (6 )%  | 1 %                       | (5 )% |
| Income tax expense                  | 0 %                       | (9 )%  | 0 %                       | (3 )% |
| Net income (loss)                   | 3 %                       | (15 )% | 1 %                       | (8 )% |

## Revenue

Our revenue is generated from the sale of software, primarily third-party software that we resell and our own proprietary software, and the sale of engineering services. Total revenue increased \$963,000, or 4%, to \$24.5 million for the three months ended September 30, 2014, from \$23.6 million in the year-ago period. Total revenue increased \$4.0 million, or 6%, to \$70.3 million for the nine months ended September 30, 2014, from \$66.3 million in the year-ago period. Both of the increases were driven by higher third-party software sales.

Revenue from customers outside of North America decreased \$0.6 million, or 23%, to \$2.1 million for the three months ended September 30, 2014 compared to \$2.7 million in the year-ago period. Revenue from customers outside of North America increased \$0.8 million, or 12%, to \$7.4 million for the nine months ended September 30, 2014 compared to \$6.6 million in the year-ago period. The increase in the nine-month period was primarily driven by higher service revenue in Japan which, in turn, was driven by two large handheld terminal projects. The decrease in the three-month period is due to the timing of engineering services on the Japan projects.

## 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, and support and maintenance revenue. Software revenue for the three and nine months ended September 30, 2014 and 2013 was as follows (dollars in thousands):

|  | Three Months Ended                |           | Nine Months Ended                 |           |                                   |      |
|--|-----------------------------------|-----------|-----------------------------------|-----------|-----------------------------------|------|
|  | September 30, 2014<br>(unaudited) | 2013      | September 30, 2014<br>(unaudited) | 2013      | September 30, 2014<br>(unaudited) | 2013 |
| Software revenue:  |                                   |           |                                   |           |                                   |      |
| Third-party software   | \$ 19,217                         | \$ 18,004 | \$ 53,877                         | \$ 49,749 |                                   |      |
| Proprietary software   | 551                               | 452       | 1,754                             | 2,069     |                                   |      |
| Total software revenue   | \$ 19,768                         | \$ 18,456 | \$ 55,631                         | \$ 51,818 |                                   |      |
| Software revenue as a percentage of total revenue                      | 81                                | % 78      | % 79                              | % 78      |                                   |      |
| Third-party software revenue as a percentage of total software revenue | 97                                | % 98      | % 97                              | % 96      |                                   |      |

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 increased \$1.2 million, or 7%, for the three months ended September 30, 2014, from the year-ago period. The improvement was driven by a \$2.9 million increase in sales of Windows Mobile operating systems driven by sales to two existing customers and was partially offset by a \$1.0 million decrease in Windows Embedded operating system sales that resulted from the timing of sales to existing customers. Third-party software revenue increased \$4.1 million, or 8%, for the nine months ended September 30, 2014, compared to the year-ago period. The increase was driven by a \$5.5 million increase in Windows Embedded operating system sales, partially offset by a \$1.1 million decrease in Adobe Flash sales. Revenue in the nine months ended September 30, 2014 further benefited from a significant sale of Windows Embedded operating systems in the amount of \$2.6 million to a single customer in the first quarter of 2014.

Proprietary software revenue increased \$99,000, or 22%, to \$551,000 for the three months ended September 30, 2014, from \$452,000 in the year-ago period, primarily driven by increases in sales of a number of our legacy products.

Proprietary software revenue decreased \$315,000, or 15%, for the nine months ended September 30, 2014, compared to the year-ago period, driven primarily by a decline in Texas Instruments OMAP royalty revenue as well as declines in sales of a number of our legacy products.

#### Service revenue

Service revenue for the three and nine months ended September 30, 2014 and 2013 was as follows (dollars in thousands):

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Service revenue                                  | \$4,767            | \$5,116            | \$14,690           | \$14,461           |
| Service revenue as a percentage of total revenue | 19 %               | 22 %               | 21 %               | 22 %               |

Service revenue decreased \$349,000, or 7%, for the three months ended September 30, 2014, from the year-ago period. This decrease was driven by lower revenue associated with the MyFord Touch program. The decrease was partially offset by small increases in service revenue in both the United Kingdom and Asia.

Service revenue increased \$229,000, or 2%, for the nine months ended September 30, 2014, compared to the year-ago period. The improvement was driven by a \$1.5 million increase in Japan which benefited from two large handheld terminal projects as well as small increases in the United Kingdom and other regions in Asia. During the nine months ended September 30, 2014, we completed one of the projects in Japan which resulted in the recognition of \$478,000 in service revenue and gross profit during the three months ended June 30, 2014. Both programs are being accounted for under the zero profit percentage of completion accounting method in which we recognize revenue during the project equal to our cost and recognize the remaining revenue, equal to the gross profit on the program, at completion. There were no such completions in the three months ended September 30, 2014. The increase was offset by a \$1.5 million decline in North America service revenue which, in turn, was driven by lower revenue on the MyFord Touch program.

We continued to work on the MyFord Touch program during the three months ended September 30, 2014, a project we began with Ford during the second quarter of 2008 and which has been significant for us since its inception. We

now perform these services through agreements with Microsoft and another customer. Service revenue from the MyFord Touch program was \$655,000 and \$1.2 million for the three months ended September 30, 2014 and 2013, respectively, and \$2.1 million and \$3.7 million for the nine months ended September 30, 2014 and 2013, respectively. These declines are primarily attributable to a reduction in the number of engineers working on the MyFord Touch project.

## 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 entire earned rebate amount was treated as a reduction of 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 of marketing expense if and when qualified program expenditures are made. Under this rebate program, we recognized \$64,000 and \$233,000, respectively, during the three and nine months ended September 30, 2014 and \$89,000 and \$658,000, respectively, during the three and nine months ended September 30, 2013, which was treated as a reduction in cost of sales. Additionally, during the three and nine months ended September 30, 2014, we qualified for \$149,000 and \$543,000, respectively, in rebate credits which will be accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

Gross profit and related gross margin for the three and nine months ended September 30, 2014 and 2013 were as follows (dollars in thousands):

|                       | Three Months<br>Ended |         | Nine Months Ended     |          |                       |  |                       |  |
|-----------------------|-----------------------|---------|-----------------------|----------|-----------------------|--|-----------------------|--|
|                       | September 30,<br>2014 |         | September 30,<br>2013 |          | September 30,<br>2014 |  | September 30,<br>2013 |  |
|                       | (unaudited)           |         | (unaudited)           |          | (unaudited)           |  | (unaudited)           |  |
| Software gross profit | \$3,008               | \$2,491 | \$8,442               | \$8,731  |                       |  |                       |  |
| Software gross margin | 15 %                  | 13 %    | 15 %                  | 17 %     |                       |  |                       |  |
| Service gross profit  | \$955                 | \$878   | \$3,321               | \$1,778  |                       |  |                       |  |
| Service gross margin  | 20 %                  | 17 %    | 23 %                  | 12 %     |                       |  |                       |  |
| Total gross profit    | \$3,963               | \$3,369 | \$11,763              | \$10,509 |                       |  |                       |  |
| Total gross margin    | 16 %                  | 14 %    | 17 %                  | 16 %     |                       |  |                       |  |

## Software gross profit and gross margin

Software gross profit increased by \$517,000, or 21%, for the three months ended September 30, 2014, from the year-ago period, and software gross margin increased by 2 percentage points to 15% from the year-ago period. The increases in software gross profit and margin were driven by an increase in proprietary software revenue compared to a relatively fixed cost base as well as increased revenue from Windows Mobile operating systems which are a higher margin product. Third-party software gross margin was 14% for the three months ended September 30, 2014, and 13% for the year-ago period, driven by the increased revenue from proprietary software and Windows Mobile operating systems. Proprietary software gross margin was 74% for the three months ended September 30, 2014, compared to 42% in the year-ago period due to the increased revenue on a relatively fixed cost base.

Software gross profit decreased by \$289,000, or 3%, for the nine months ended September 30, 2014, from the year-ago period, and software gross margin decreased by 2 percentage points to 15% from the year-ago period. The decrease in software gross profit was driven by a decrease in proprietary software revenue that has a relatively fixed cost base as well as a shift in product mix to lower margin Microsoft Embedded operating systems. Third-party software margin was 13% and 15% for the nine months ended September 30, 2014 and 2013, respectively, with the



decline driven by the shift in products to lower margin Microsoft Embedded operating systems. Proprietary software margin was 72% for the nine months ended September 30, 2014, compared to 68% in the year-ago period.

#### Service gross profit and gross margin

Service gross profit increased by \$77,000, or 9%, for the three months ended September 30, 2014, from the year-ago period. Service gross margin increased by 3 percentage points to 20% for the three months ended September 30, 2014, compared to the year-ago period. The increase in service gross profit was driven by a decline in cost of sales made possible by improvement in utilization that resulted largely from headcount reductions that occurred in the fourth quarter of 2013. The gross margin improvement resulted from an increase in our realized rate per hour.

Service gross profit increased \$1.5 million, or 87%, for the nine months ended September 30, 2014, from \$1.8 million in the year-ago period driven by the same factors that accounted for the three-month increase as well as the impact of recognizing the \$478,000 of gross profit on the previously mentioned service project completed in Japan in the second quarter of 2014. Service gross margin increased 11 percentage points to 23% for the nine months ended September 30, 2014, compared to the year-ago period. The margin improvement was driven by a decline in our cost per billable hour resulting from utilization improvement, offset in part by a decline in our realized rate per hour.

## Operating expenses

### Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and related benefits, commissions for our sales teams, marketing and administrative personnel and related facilities and depreciation costs, as well as professional services fees (e.g., consulting, legal, tax and audit). Selling, general and administrative expenses decreased \$1.1 million, or 27%, to \$2.9 million for the three months ended September 30, 2014, from \$4.0 million in the year-ago period. The decrease was driven primarily by lower headcount-related costs resulting from restructuring and other reductions as well as decreased facilities and travel expenses. Selling, general and administrative expenses represented 12% of our total revenue for the three months ended September 30, 2014 and 17% in the year-ago period.

Selling, general and administrative expenses decreased \$2.0 million, or 18%, to \$9.4 million for the nine months ended September 30, 2014, from \$11.4 million in the year-ago period. The decrease was due to the same factors accounting for the decrease for the three-month period. Selling, general and administrative expenses represented 13% of our total revenue for the nine months ended September 30, 2014 and 18% for the year-ago period.

### 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 \$444,000, or 55%, to \$360,000 for the three months ended September 30, 2014, from \$804,000 in the year-ago period due primarily to headcount and other expense reductions that took place in the fourth quarter of 2013. Research and development expenses represented 1% of our total revenue for the three months ended September 30, 2014 and 3% in the year-ago period.

Research and development expenses decreased \$1.0 million, or 45%, to \$1.2 million for the nine months ended September 30, 2014, from \$2.2 million in the year-ago period. This decrease was driven by the same factors that accounted for the three-month decrease. Research and development expenses represented 2% of our total revenue for the nine months ended September 30, 2014 and 3% for the year-ago period.

### Other income (expense), net

Other income or expense consists of interest income on our cash, cash equivalents and investments, gains and/or losses recognized on our investments, as well as gains or losses on foreign exchange transactions. Other expense increased \$1,000 to \$16,000 for the three months ended September 30, 2014, compared to the year-ago period, due to foreign currency transaction losses.

Other expense was \$118,000 for the nine months ended September 30, 2014, compared to other income of \$100,000 for the year-ago period, also as a result of net foreign currency transaction losses and gains, respectively.

### Income tax expense

Income tax expense was \$16,000 for the three months ended September 30, 2014, compared to \$2.2 million in the year-ago period, a decrease of \$2.1 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 the US deferred tax assets. As a result, we recorded a valuation allowance of \$2.2 million at that time with a resulting charge to income tax expense. Deferred tax assets relative to our foreign jurisdictions were already subject to a full valuation allowance.

Income tax expense decreased \$2.1 million to \$0.1 million for the nine months ended September 30, 2014, compared to \$2.2 million in the year-ago period due to the same factors that accounted for the three-month change.

The effective tax rates for the three and nine months ended September 30, 2014 of 2% and 12%, respectively, were lower than the U.S. statutory rate of 34% because of net operating losses available to offset current year taxable income and a full valuation allowance on deferred tax assets. The effective tax rates for the three and nine months ended September 30, 2013 of 153% and 73%, respectively, were higher than the U.S. statutory rate of 34% primarily due to a \$2.2 million charge recorded to increase the valuation allowance on deferred tax assets.

#### Liquidity and Capital Resources

As of September 30, 2014, we had \$25.5 million of cash, cash equivalents, short-term and long-term investments and restricted cash, compared to \$21.1 million at December 31, 2013.

Net cash provided by operating activities was \$4.1 million for the nine months ended September 30, 2014, driven primarily by net income, positive net working capital changes and non-cash charges. Net cash provided by operating activities was \$1.2 million for the nine months ended September 30, 2013, driven by positive net working capital changes and non-cash charges, which were offset in part by our \$5.2 million net loss for such period.

Investing activities used cash of \$5.6 million for the nine months ended September 30, 2014, due to a net increase in short-term investments of \$5.3 million and capital expenditures of \$276,000. Investing activities provided cash of \$2.2 million for the nine months ended September 30, 2013 due to a \$1.8 million reduction in short-term investments and a \$625,000 reduction in restricted cash as a result of amending our headquarters lease, offset by capital expenditures of \$216,000.

Financing activities generated \$595,000 during the nine months ended September 30, 2014, and \$12,000 during the nine months ended September 30, 2013, as a result of employees' exercise of stock options.

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

#### Cash Commitments

We have the following future or potential cash commitments:

Minimum rents payable under operating leases total \$301,000 for the remainder of 2014, \$1.3 million in 2015 and 2016, \$1.2 million in 2017, \$1.1 million in 2018, \$1.0 million in 2019 and \$0.4 million 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 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 significant 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 relating to active agreements.

#### Recently Issued Accounting Standards

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

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**  
Not applicable.

#### Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that the information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded,

processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Acting Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Our management carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Acting Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, our Chief Executive Officer and Acting Principal Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes in our internal controls over financial reporting during the three months ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1A. Risk Factors

There have been no material changes in the risk factors set forth in Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013, and in Part II, Item 1A, “Risk Factors” in our Quarterly Reports on Forms 10-Q for the periods ended March 31 and June 30, 2014.

### Item 5. Other Information

Our Board of Directors has authorized Jerry D. Chase, our President and Chief Executive Officer, to also serve as our “Acting Principal Financial Officer” solely in connection with the review, execution and certification of this Quarterly Report on Form 10-Q for the quarter ended September 30, 2014.

### Item 6. Exhibits

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

SIGNATURES

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

BSQUARE CORPORATION

(Registrant)

Date: November 13, 2014 By: /s/ JERRY D. CHASE

Jerry D. Chase

President, Chief Executive Officer and Acting Principal Financial Officer

## BSQUARE CORPORATION

## INDEX TO EXHIBITS

| Exhibit<br>Number | Description  | Filed or<br>Furnished Incorporated by Reference |      |             |         |           |
|-------------------|--|---|------|-------------|---------|-----------|
|                   |  | Herewith  | Form | 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 |
| 31.1              | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934  | X   |      |             |         |           |
| 31.2              | Certification of Acting Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934   | X   |      |             |         |           |
| 32.1              | Certification of Chief Executive Officer and Acting Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X   |      |             |         |           |
| 101.INS           | XBRL Instance Document   | X   |      |             |         |           |
| 101.SCH           | XBRL Taxonomy Extension Schema   | X   |      |             |         |           |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase   | X   |      |             |         |           |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase  | X   |      |             |         |           |
| 101.LAB           | XBRL Taxonomy Extension Label Linkbase   | X   |      |             |         |           |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase  | X   |      |             |         |           |