BSQUARE CORP /WA
Form 10-Q
August 07, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from __________ to __________

Commission File Number: 000-27687

BSQUARE CORPORATION
(Exact name of registrant as specified in its charter)

Washington	**91-1650880**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
110 110th Avenue NE, Suite 200, Bellevue WA	**98004**
(Address of principal executive offices)	(Zip Code)

(425) 519-5900
(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 þ No o

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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

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

The number of shares of common stock outstanding as of July 31, 2008: 10,032,449

BSQUARE CORPORATION
FORM 10-Q
For the Quarterly Period Ended June 30, 2008
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

BSQUARE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	June 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,958	$ 4,377
Short-term investments		9,575
Accounts receivable, net of allowance for doubtful accounts of $198 at June 30, 2008 and $199 at December 31, 2007	9,068	8,273
Prepaid expenses and other current assets	630	377
Total current assets	18,656	22,602
Long-term investments	6,525	
Equipment, furniture and leasehold improvements, net	977	824
Intangible assets, net	186	230
Restricted cash	900	1,050
Other non-current assets	71	56
Total assets	$ 27,315	$ 24,762
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,103	$ 2,619
Other accrued expenses	2,442	2,877
Accrued compensation	1,555	1,393
Accrued legal fees	534	534
Deferred revenue	575	493
Total current liabilities	8,209	7,916
Deferred rent	317	331
Commitments and contingencies (Note 6)		
Shareholders equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 10,030,699 shares issued and outstanding at June 30, 2008 and 9,967,618 shares issued and outstanding at December 31, 2007	121,941	121,118
Accumulated other comprehensive loss	(308)	(409)
Accumulated deficit	(102,844)	(104,194)

Total shareholders equity		18,789		16,515
Total liabilities and shareholders equity	$	27,315	$	24,762

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenue:				
Software	$ 9,680	$ 10,182	$ 20,676	$ 19,377
Service	5,746	4,912	11,808	10,813
Total revenue	15,426	15,094	32,484	30,190
Cost of revenue:				
Software	7,675	7,937	16,072	14,759
Service [1]	3,975	3,650	7,986	7,927
Total cost of revenue	11,650	11,587	24,058	22,686
Gross profit	3,776	3,507	8,426	7,504
Operating expenses:				
Selling, general and administrative [1]	2,983	2,703	5,992	5,600
Research and development [1]	561	598	1,205	1,143
Total operating expenses	3,544	3,301	7,197	6,743
Income from operations	232	206	1,229	761
Interest and other income	88	444	248	567
Income before income taxes	320	650	1,477	1,328
Income tax expense	(10)	(108)	(127)	(148)
Net income	$ 310	$ 542	$ 1,350	$ 1,180
Basic income per share	$ 0.03	$ 0.06	$ 0.14	$ 0.12
Diluted income per share	$ 0.03	$ 0.05	$ 0.13	$ 0.12
Shares used in the calculation of income per share:				
Basic	10,011	9,823	9,994	9,750
Diluted	10,253	10,190	10,284	10,010

(1) Includes the following amounts related

to non-cash stock-based compensation expense:				
Cost of revenue service	$ 102	$ 60	$ 227	$ 108
Selling, general and administrative	227	170	467	290
Research and development	26	12	45	33
Total stock-based compensation expense	$ 355	$ 242	$ 739	$ 431

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six Months Ended June 30,	
	2008	**2007**
Cash flows from operating activities:		
Net income	$ 1,350	$ 1,180
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	265	294
Stock-based compensation	739	431
Changes in operating assets and liabilities:		
Accounts receivable, net	(738)	(2,323)
Prepaid expenses and other assets	(263)	65
Accounts payable and accrued expenses	204	1,419
Deferred revenue	74	54
Deferred rent	(14)	(12)
Net cash provided by operating activities	1,617	1,108
Cash flows from investing activities:		
Purchases of equipment and furniture	(367)	(267)
Proceeds from reduction of restricted cash	150	150
Purchases of investments		(3,144)
Maturities of investments	3,050	
Net cash provided by (used in) investing activities	2,833	(3,261)
Cash flows from financing activities:		
Proceeds from exercise of stock options	84	685
Net cash provided by financing activities	84	685
Effect of exchange rate changes on cash	47	(4)
Net increase (decrease) in cash and cash equivalents	4,581	(1,472)
Cash and cash equivalents, beginning of period	4,377	2,483
Cash and cash equivalents, end of period	$ 8,958	$ 1,011

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2008
(unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by BSQUARE Corporation (the Company or BSQUARE) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting and include the accounts of the Company and its subsidiaries. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited financial statements reflect all material adjustments, which consist solely of normal recurring adjustments, necessary to present fairly the Company s financial position as of June 30, 2008 and its operating results and cash flows for the three and six months ended June 30, 2008 and 2007. The accompanying financial information as of December 31, 2007 is derived from audited financial statements. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provision for bad debts and income taxes and estimates of progress on professional service arrangements. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this quarterly report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained in the Company s annual report on Form 10-K for the year ended December 31, 2007 filed with the SEC. All intercompany balances have been eliminated.

Earnings Per Share

Basic earnings 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 stock options. Diluted earnings 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 antidilutive. Common stock equivalent shares were 2,096,663 at June 30, 2008 and 1,084,735 at June 30, 2007.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Weighted average shares outstanding for basic earnings per share	10,011	9,823	9,994	9,750
Dilutive effect of common stock equivalent shares	242	367	290	260
Weighted average shares outstanding for diluted earnings per share	10,253	10,190	10,284	10,010

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2. Investments

The Company s investments consist of auction rate securities, or ARS. ARS are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long term, they were generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed.) The Company had investments in ARS valued at $6,525,000 as of June 30, 2008 which have failed at auction. These investments are illiquid and the Company is unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is contingent on redeeming the investments by the issuers or sales of the securities in a secondary market. ARS are currently being sold on the secondary market at discounts that range from 5% to 25% depending on the type of security. The failed ARS carry AAA ratings and continue to pay interest according to the stated terms. There has been no reduction in fair value of the underlying collateral of the Company s ARS portfolio. Although we are uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be only temporary. It is possible that declines in fair value may occur in the future. If the credit ratings of the issuer, the bond insurers or the collateral deteriorate, the Company may adjust the carrying value of these investments. If the current market conditions deteriorate further, the Company may be required to record unrealized losses in other comprehensive income or impairment charges. As of June 30, 2008, the Company has reclassified the balance of ARS on its balance sheet from short-term investments to long-term investments due to the uncertainty in timing of liquidating these investments.

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS No. 157) as of January 1, 2008 to measure the fair value of its ARS. Under SFAS No. 157, based on the observability of the inputs used in the valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted prices (unadjusted) 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.

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Fair value measurements of the Company s ARS as of June 30, 2008 were as follows:

	Fair Value Measurements as of June 30, 2008 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(in thousands)			
Auction rate securities:				
Student loan backed	$	$	$ 4,050	$ 4,050
Closed-end funds			1,975	1,975
Corporate collateral			500	500
Total auction rate securities	$	$	$ 6,525	$ 6,525
Amounts included in:				
Short-term investments	$	$	$	$
Long-term investments			6,525	6,525
Total	$	$	$ 6,525	$ 6,525

Based on market conditions, the Company changed its valuation methodology for auction rate securities to a valuation method that includes market and income approaches during the second quarter of fiscal 2008. The following table reconciles the beginning and ending balances for auction rate securities using significant unobservable inputs (Level 3):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3):			
	Student Loan Backed	Closed-end Funds	Corporate Collateral	Total
	(in thousands)			
Balance at March 31, 2008	$	$	$	$
Transfers in to Level 3	4,050	1,975	500	6,525
Balance at June 30, 2008	$ 4,050	$ 1,975	$ 500	$ 6,525

During the three months ended June 30, 2008, ARS valued at $1,750,000 were redeemed by their issuers at par. During the six months ended June 30, 2008, ARS valued at $2,250,000 were redeemed by their issuers at par.

3. Intangible Assets

Intangible assets relate to technology and other assets acquired from NEC Corporation of America in December 2007.

	June 30, 2008	December 31, 2007
Gross carrying value of the acquired intangible assets subject to amortization	$ 230	$ 230
Accumulated amortization	44	
Net book value	$ 186	$ 230

Amortization expense was $22,000 for the three months ended June 30, 2008 and $51,000 for the three months ended June 30, 2007. Amortization expense was $44,000 for the six months ended June 30, 2008 and $101,000 for six months ended June 30, 2007. Amortization expense in 2007 related to technology acquired from Vibren Technologies, Inc. in June 2005. These assets were fully amortized as of June 30, 2007. Amortization expense is expected to be $44,000 for the remainder of 2008.

4. Stock-Based Compensation

Stock Options

In May 1997, the Company adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at prices determined by the Board, not to be less than 85% of the fair market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under the Amended Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of the Company s stock. The Amended Plan also allows for awards of stock appreciation rights, restricted and unrestricted stock and restricted stock units.

The Company also has a Non-Qualified Stock Option Plan, under which the Board of Directors may grant non-qualified stock options at prices determined by the Board. These stock options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally over four years.

Restricted Stock Awards

In August 2007, the Company began issuing restricted stock awards to its Board of Directors. These awards are subject to forfeiture until the twelve-month anniversary of the grant date. In December 2007, the Company began issuing restricted stock units to employees. These awards are subject to forfeiture for a period of four years. In January 2008, the Company began issuing restricted stock awards to its officers. These awards are subject to forfeiture for a period of 23 months.

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Stock-Based Compensation

The Company records compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. The Company records expense over the vesting period using the straight-line method. The calculation of compensation expense for awards under SFAS 123R includes the impact of an estimate for forfeitures.

Stock-based compensation expense is recorded in the statements of income in the same line items as cash compensation for the Company s employees as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Cost of revenue service	$ 102	$ 60	$ 227	$ 108
Selling, general and administrative	227	170	467	290
Research and development	26	12	45	33
Total stock-compensation expense	$ 355	$ 242	$ 739	$ 431

Stock-based compensation expense under SFAS123R reduced net income by $355,000 and diluted earnings per share by $0.03 for the three months ended June 30, 2008 and reduced net income by $739,000 and diluted earnings per share by $0.07 for the six months ended June 30, 2008. Stock-based compensation expense under SFAS123R reduced net income by $242,000 and diluted earnings per share by $0.02 for the three months ended June 30, 2007 and reduced net income by $431,000 and diluted earnings per share by $0.04 for the six months ended June 30, 2007.

At June 30, 2008, compensation expense related to stock options granted under the Company s Stock Option Plan, but not yet recognized, was $591,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

At June 30, 2008, compensation expense related to restricted stock awards granted under the Company s Stock Option Plan, but not yet recognized, was $90,000. This cost will be amortized on the straight-line method over a period of approximately six months.

At June 30, 2008, compensation expense related to restricted stock units granted under the Company s Stock Option Plan, but not yet recognized, was $263,000. This cost will be amortized on the straight-line method over a period of approximately 1.7 years.

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Key Assumptions

The fair value of the Company s options was estimated on the date of grant using the Black-Scholes-Merton option pricing model, with the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	79%	86%	80%	86%
Risk-free interest rate	3.0%	4.7%	2.7%	4.7%
Estimated forfeitures	22%	34%	22%	34%

Expected Dividend The Black-Scholes-Merton valuation model calls for a single expected dividend yield as an input. The dividend yield is determined by dividing the expected per share dividend during the coming year by the grant date stock price. The expected dividend assumption is based on the Company s current expectations about its anticipated dividend policy.

Expected Life: The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined based on historical experience and vesting schedules of similar awards.

Expected Volatility: The Company s expected volatility represents the weighted average historical volatility of the Company s common stock for the most recent four-year period.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used in the Black-Scholes-Merton valuation method on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. Where the expected term of the Company s stock-based awards do not correspond with the terms for which interest rates are quoted, the Company performed a straight-line interpolation to determine the rate from the available term maturities.

Estimated Forfeitures: Estimated forfeitures represents the Company s historical forfeitures for the most recent two-year period and considers voluntary termination behavior as well as analysis of actual option forfeitures.

Stock Option Activity

The following table summarizes stock option activity under the Company s Stock Option Plan for the six months ended June 30, 2008:

Stock Options	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	1,886,717	$	4.36		
Granted at fair value	190,200		4.23		
Exercised	(32,845)		2.58		
Forfeited	(22,820)		2.95		
Expired	(12,397)		18.77		
Outstanding at June 30, 2008	2,008,855	$	4.31	7.02	$ 2,847,000
Vested and expected to vest at June 30, 2008	1,685,279	$	4.43	6.76	$ 2,417,000
Exercisable at June 30, 2008	1,309,663	$	4.62	6.28	$ 1,955,000

The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of the Company s common stock for the number of options that were in-the-money at June 30, 2008. The Company issues new shares of common stock upon exercise of stock options.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Weighted-average grant-date fair value	$ 3.30	$ 3.65	$ 2.95	$ 3.31
Aggregate intrinsic value of options exercised	$ 57,000	$ 264,000	$ 80,000	$ 627,000

There were 1,012,052 options in-the-money as of June 30, 2008 and 834,928 options in-the-money as of June 30, 2007.

Restricted Stock Activity

The following table summarizes restricted stock award activity under the Company s Stock Option Plan for the three months ended June 30, 2008:

	Number of Shares		Weighted Average Grant Date Fair Value
Outstanding at January 1, 2008	21,000	$	6.32
Awarded	21,000	$	5.11

Released			
Forfeited			
Outstanding at June 30, 2008	42,000	$	5.72

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The following table summarizes restricted stock unit activity under the Company s Stock Option Plan for the three months ended June 30, 2008:

	Number of Shares	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	94,728		
Awarded	22,817		
Released	(11,396)		
Forfeited	(5,578)		
Outstanding at June 30, 2008	100,571	1.66	$ 486,000
Vested and expected to vest at June 30, 2008	60,532	1.43	$ 292,000

The weighted-average grant-date fair value of restricted stock units granted was $5.79 for the six months ended June 30, 2008.

Warrants

In June 2003, as a result of a lease restructuring agreement, the Company issued warrants to purchase up to 100,000 shares of the Company s common stock at an exercise price of $4.56 per share. The warrants expired in June 2008.

5. Comprehensive Income (Loss)

Comprehensive income (loss) consists of two components, net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders equity under generally accepted accounting principles but are excluded from net income (loss). The Company s other comprehensive income (loss) is comprised of foreign currency translation adjustments from its subsidiaries not using the U.S. dollar as their functional currency. The components of other comprehensive income (loss) consisted of a foreign currency translation gain of $53,000 for the three months ended June 30, 2008 and a foreign currency translation loss of $1,000 for the three months ended June 30, 2007. The components of other comprehensive income (loss) consisted of a foreign currency translation gain of $101,000 for the six months ended June 30, 2008 and a foreign currency translation loss of $13,000 for the six months ended June 30, 2007.

6. Commitments and Contingencies

Contractual Commitments

The Company s principal commitments consist of obligations outstanding under operating leases, which expire through 2014. The Company has lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Boston, Massachusetts; Vancouver, Canada; Taipei, Taiwan; and Tokyo, Japan. The Company leases office space in Akron, Ohio on a month-to-month basis.

In February 2004, the Company amended the lease of its former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters. If the Company defaults under its corporate headquarters lease, the landlord has the ability to demand repayment for certain cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was $1.5 million at June 30, 2008, which decreases on the straight-line basis over the length of its ten-year headquarters lease.

Rent expense was $299,000 for the three months ended June 30, 2008 and $270,000 for the three months ended

June 30, 2007. Rent expense was $578,000 for the six months ended June 30, 2008 and $542,000 for the six months ended June 30, 2007.

As of June 30, 2008, the Company had $900,000 pledged as collateral for a bank letter of credit under the terms of its headquarters facility lease. The pledged cash supporting the outstanding letter of credit is classified as restricted cash.

Contractual commitments at June 30, 2008 were as follows (in thousands):

Operating leases:	
Remainder of 2008	$ 636
2009	1,164
2010	1,127
2011	1,039
2012	1,030
Thereafter	1,860
Total commitments	$ 6,856

Legal Proceedings

IPO Litigation

In Summer and early Fall 2001, four purported shareholder class action lawsuits were filed in the United States District Court for the Southern District of New York against the Company, certain of the Company s current and former officers and directors (the Individual Defendants), and the underwriters of the Company s initial public offering (the Underwriter Defendants). The complaints were consolidated into a single action and a Consolidated Amended Complaint, which was filed on April 19, 2002, is now the operative complaint. The operative complaint alleges violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The suit purports to be a class action filed on behalf of purchasers of the Company s common stock during the period from October 19, 1999 to December 6, 2000.

The plaintiffs allege that the Underwriter Defendants agreed to allocate stock in the Company s initial public offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. The plaintiffs allege that the prospectus for the Company s initial public offering was false and misleading in violation of the securities laws because the Company did not disclose these arrangements. The action seeks damages in an unspecified amount.

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On December 5, 2006, the Second Circuit vacated a decision by the district court granting class certification in six of the coordinated cases, which are intended to serve as test, or focus, cases. The plaintiffs selected these six cases, which do not include the Company. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by the plaintiffs, but noted that the plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The amended complaints include a number of changes, such as changes to the definition of the purported class of investors, and the elimination of the individual defendants as defendants. On September 27, 2007, the plaintiffs moved to certify a class in the six focus cases. On November 14, 2007, the issuers and the underwriters named as defendants in the six focus cases filed motions to dismiss the amended complaints. On March 26, 2008, the district court dismissed the Securities Act claims of those members of the putative classes in the focus cases who sold their securities for a price

in excess of the initial offering price and those who purchased outside the previously certified class period. With respect to all other claims, the motions to dismiss were denied. The Company is awaiting a decision from the Court on the class certification motion. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of this matter. If the Company is found liable, the Company is unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company s insurance coverage, and whether such damages would have a material impact on the Company s results of operations or financial condition in any future period.

7. Segment Information

The Company follows the requirements of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. The Company has one operating segment software and services delivered to smart device makers.

The following table summarizes information about the Company s revenue and long-lived asset information by geographic areas (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Total revenue:				
North America	$ 14,315	$ 14,137	$ 29,701	$ 28,452
Asia	1,001	944	2,435	1,713
Other foreign	110	13	348	25
Total revenue (1)	$ 15,426	$ 15,094	$ 32,484	$ 30,190

	June 30, 2008	December 31, 2007
Long-lived assets:		
North America	$ 990	$ 1,017
Asia	173	37
Total long-lived assets	$ 1,163	$ 1,054

(1) Revenue is attributed to countries based on the location of the customer invoiced.

Significant Customers

No customers accounted for 10% or more of total revenue for the three or six months ended June 30, 2008. One customer had an accounts receivable balance of approximately $1.2 million, or 13% of total accounts receivable as of June 30, 2008. Approximately $245,000 of this balance was past due as of June 30, 2008 and the remaining balance was current. As of July 31, 2008, the Company had collected $163,000 of the June 30, 2008 balance from this customer.

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

From time to time, information provided by us, statements made by our employees or information included in our filings with the Securities and Exchange Commission (SEC) may contain statements that are forward-looking statements involving risks and uncertainties. In particular, statements in Management s Discussion and Analysis of Financial Condition and Results of Operations relating to our revenue, profitability, growth initiatives and sufficiency of capital may be forward-looking statements. The words expect, anticipate, plan, believe, seek, estimate and expressions are intended to identify such forward-looking statements. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that could cause our future results to differ materially from those expressed in any forward-looking statements made by, or on behalf of, us. Many such factors are beyond our ability to control or predict. Readers are accordingly cautioned not to place undue reliance on forward-looking statements. We disclaim any intent or obligation to update any forward-looking statements, whether in response to new information or future events or otherwise. Important factors that may cause our actual results to differ from such forward-looking statements include, but are not limited to, the factors discussed in Item 1A of Part II of this quarterly report, our quarterly report for the quarterly period ended March 31, 2008 and of Part I of our annual report on Form 10-K for the year ended December 31, 2007 entitled Risk Factors.

Overview

We provide software and engineering services to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) and may be connected to a network via a wired or wireless connection. Examples of smart devices include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, PDAs, handheld data collection devices, personal media players and smartphones. We primarily focus the sale of our software and engineering services to customers developing smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile . However, with our recent acquisition of customers and rights to license Adobe Flash Lite technology from NEC Corporation of America, we expect to support customers who are using Adobe Flash Lite technology in other operating systems such as Linux and Symbian.

We have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs), silicon vendors (SVs), peripheral vendors, and enterprises with customized device needs such as retailers and wireless operators that market and distribute connected smart devices. The software and engineering services we provide our customers are delivered, utilized and deployed throughout various phases of our customers device life cycle, including design, development, customization, quality assurance and deployment.

Critical Accounting Judgments

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company s critical accounting policies as those that are most important to the portrayal of its financial condition and results of operations, and those that require a company to make its most difficult and subjective judgments, often as a result of the need to make estimates related to matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are relevant to understanding our results. For additional information see Item 1 of Part I, Financial Statements Note 1 Summary of Significant Accounting Policies. Although we believe that our estimates, assumptions and judgments are reasonable, they are necessarily based upon presently available information. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

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, time records and customer acceptance, as and when applicable, are 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.

We recognize software revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. Service revenue from time and materials contracts and training services is recognized as services are performed. For certain fixed-price professional engineering service contracts that require significant production, modification, or customization of software, we account for these arrangements using the percentage-of-completion method under Statement Of Position (SOP) 81-1, as contemplated by paragraph 7 of SOP 97-2. We use the percentage-of-completion method of accounting specified within SOP 81-1, as contrasted to alternative approaches outlined in SOP 81-1, because it is the most preferable method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; it is a better measure of periodic income results than other methods in our case and it better matches revenue recognized with the costs incurred in our instance. 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. We rely on estimates of total expected hours as a measure of performance in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period 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 or maintenance (PCS). As a result, significant 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, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. PCS includes 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 VSOE have an impact on 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, we allocate revenue first to the fair value of the undelivered elements and allocate the residual revenue to the delivered elements. In the absence of fair value for an undelivered element, the arrangement is accounted for as a single unit of accounting, resulting in a delay of revenue recognition for the delivered elements until the undelivered elements are fulfilled. As a result, contract interpretations and assessments of fair value are sometimes required to determine the appropriate accounting.

When elements such as 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, some of which may be guaranteed. We recognize royalty revenue when we receive the royalty report from the customer or when such royalties are contractually guaranteed and the revenue recognition criteria are met, particularly that collectability is reasonably assured.

Deferred revenue includes deposits received from customers for service contracts, customer advances under OEM licensing agreements and unamortized maintenance and support contract revenue.

Allowance for Doubtful Accounts

Our accounts receivable balances are net of an estimated allowance for doubtful accounts. We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We estimate the collectability of our accounts receivable and record an allowance for doubtful accounts. We consider many factors when making this estimate, including analyzing accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history, when evaluating the adequacy of the allowance for doubtful accounts. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimated reserve.

Investments

We account for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). We adopted SFAS No. 157, Fair Value Measurements (SFAS No. 157) as of January 1, 2008 to measure the fair value of certain of our financial assets required to be measured on a recurring basis, including available-for-sale securities. Under SFAS No. 157, based on the observability of the inputs used in the valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted prices (unadjusted) 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.

As of June 30, 2008, we had investments in auction rate securities (ARS) valued $6.5 million. These investments are illiquid and we are unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is contingent on redeeming the investments by the issuers or sales of the securities in a secondary market. ARS are currently being sold on the secondary market at discounts that range from 5% to 25% depending on the type of security. The failed ARS carry AAA ratings and continue to pay interest according to the stated terms. There has been no reduction in fair value of the underlying collateral of our ARS portfolio. Although we are uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be only temporary. It is possible that declines in fair value may occur in the future. If the credit ratings of the issuer, the bond insurers or the collateral deteriorate, we may adjust the carrying value of these investments. If the current market conditions deteriorate further, we may be required to record unrealized losses in other comprehensive income or impairment charges. As of June 30, 2008, we have reclassified the balance of ARS on our balance sheet from short-term investments to long-term investments due to the uncertainty in timing of liquidating these investments.

Stock-Based Compensation

We record compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. We record expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

At June 30, 2008, total compensation cost related to stock options granted under our Stock Option Plan but not yet recognized was $591,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

At June 30, 2008, total compensation cost related to restricted stock awards granted under our Stock Option Plan but not yet recognized was $90,000. This cost will be amortized on the straight-line method over a period of approximately 5 months.

At June 30, 2008, total compensation cost related to restricted stock units granted under our Stock Option Plan but not yet recognized was $263,000. This cost will be amortized on the straight-line method over a period of approximately 1.7 years.

Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the countries in which we operate. This process involves estimating our current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance, or increase this allowance in a period, it may result in an expense within the tax provision in the statements of operations. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have provided a full valuation allowance on deferred tax assets because of our uncertainty regarding their realizability. If we determine that it is more likely than not that the deferred tax assets would be realized, the valuation allowance would be reversed. In order to realize our deferred tax assets, we must be able to generate sufficient taxable income.

Because we do business in foreign tax jurisdictions, our sales may be subject to other taxes, particularly withholding and earnings distribution taxes. The tax regulations governing these other taxes are complex, causing us to have to make assumptions about the appropriate tax treatment and estimates of such taxes.

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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 future results.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
Revenue:				
Software	63%	67%	64%	64%
Service	37	33	36	36
Total revenue	100	100	100	100
Cost of revenue:				
Software	50	53	49	49
Service	26	24	25	26
Total cost of revenue	76	77	74	75
Gross profit	24	23	26	25
Operating expenses:				
Selling, general and administrative	19	18	18	19
Research and development	4	4	4	4
Total operating expenses	23	22	22	23
Income from operations	1	1	4	2
Interest and other income	1	3		2
Income before income taxes	2	4	4	4
Income tax expense		(1)		
Net income	2%	4%	4%	4%

Revenue

Total revenue consists of sales of software and engineering services to smart device makers. Software revenue consists of sales of third-party software and sales of our own proprietary software products which include software licenses, software development kits and smart device reference designs as well as royalties from our software products and royalties from certain engineering service contracts. Engineering service revenue is derived from hardware and software development activities, support contracts, fees for customer training, and rebillable expenses.

Total revenue was $15.4 million for the three months ended June 30, 2008 and $15.1 million for the three months ended June 30, 2007, representing an increase of $300,000, or 2%. This increase was due to higher sales of professional engineering services, partially offset by lower software sales. Total revenue was $32.5 million for the six months ended June 30, 2008 and $30.2 million for the six months ended June 30, 2007, representing an increase of $2.3 million, or 8%. This increase was due to higher sales of both software and professional engineering services.

Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and engineering services billed to foreign customers from our operations located in North

America. We currently have operations outside North America in Taipei, Taiwan and Tokyo, Japan. Revenue from customers located outside of North America was $1.1 million for the three months ended June 30, 2008 and $944,000 for the three months ended June 30, 2007, representing an increase of $156,000, or 17%. Revenue from customers located outside of North America was $2.8 million for the six months ended June 30, 2008 and $1.7 million for the six months ended June 30, 2007, representing an increase of $1.1 million, or 65%. This increase was primarily due to a 200% increase in Asia Pacific service revenue as well as international sales of Flash Lite, of which there was none for the six months ended June 30, 2007.

Software revenue

Software revenue for the three and six months ended June 30, 2008 and 2007 is presented below (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(unaudited)		**(unaudited)**	
Software revenue:				
Third-party software	$ 9,004	$ 9,148	$ 19,137	$ 17,373
Proprietary software	676	1,034	1,539	2,004
Total software revenue	$ 9,680	$ 10,182	$ 20,676	$ 19,377
Software revenue as a percentage of total revenue	63%	67%	64%	64%
Third-party software revenue as a percentage of total software revenue	93%	90%	93%	90%

The vast majority of our third-party software revenue is comprised of the resale of Microsoft Embedded operating systems. The biggest portion of our proprietary software revenue is attributable to royalty revenue from service contracts.

Third-party software revenue was $9.0 million for the three months ended June 30, 2008 and $9.1 million for the three months ended June 30, 2007, representing a decrease of $100,000, or 1%. This decrease in third-party software revenue was due primarily to the effect of one large sale of approximately $1.5 million that benefitted the three months ended June 30, 2007, partially offset by sales of Flash Lite software, which began in December 2007 and sales of Solidcore S3 Control licensing, which began in March 2008. We generated $237,000 in Flash Lite licensing revenue for the three months ended June 30, 2008 compared to none for the three months ended June 30, 2007. We generated $345,000 in Solidcore S3 Control licensing revenue for the three months ended June 30, 2008 compared to none for the three months ended June 30, 2007.

Third-party software revenue was $19.1 million for the six months ended June 30, 2008 and $17.4 million for the six months ended June 30, 2007, representing an increase of $1.7 million, or 10%. This increase was due to $1.1 million in revenue from the licensing of Flash Lite and Solidcore S3 Control that were not present in the same period in 2007 coupled with slightly higher sales of Microsoft embedded operating systems.

We currently expect third-party software revenue to increase approximately 15% in fiscal year 2008, as compared to fiscal 2007, based on overall growth in the general embedded market, and in Microsoft s share of that market, as well increased revenue contribution from additional third-party software product offerings such as Adobe Flash Lite and Solidcore s S3 Control product.

Proprietary software revenue was $676,000 for the three months ended June 30, 2008 and $1.0 million for the three months ended June 30, 2007, representing a decrease of $324,000, or 32%. Proprietary software revenue was $1.5 million for the six months ended June 30, 2008 and $2.0 million for the six months ended June 30, 2007, representing a decrease of $500,000, or 25%. These decreases were due to lower SDIO revenue and lower service contract royalties as certain guaranteed minimum royalties expired. Royalty revenue from service contracts was $303,000 for the three months ended June 30, 2008 and $403,000 for the three months ended June 30, 2007. Royalty revenue was $675,000 for the six months ended June 30, 2008 and $759,000 for the six months ended June 30, 2007.

We currently expect proprietary software revenue to decrease 30% to 35% in fiscal 2008 primarily due to lower SDIO revenue, lower royalty revenue from Asia Pacific region service contracts as the royalty periods expire, partially offset by increased reference design and related product revenue.

Service revenue

Service revenue was $5.7 million for the three months ended June 30, 2008 and $4.9 million for the three months ended June 30, 2007, representing an increase of $800,000, or 16%. Service revenue represented 37% of total revenue for the three months ended June 30, 2008 and 33% of total revenue for the three months ended June 30, 2007. This increase was primarily due to growth in North America driven by an increase in overall customer and project count partially offset by lower average project revenue and a decline in rebillable service revenue of $202,000. Billable hours increased by 27% for the three months ended June 30, 2008, driven by higher activity levels in both the North American and Asia Pacific regions, whereas the realized rate per hour decreased by 5% due to a drop in the Asia Pacific region driven by revenue recognition delays.

Service revenue was $11.8 million for the six months ended June 30, 2008 and $10.8 million for the six months ended June 30, 2007, representing an increase of $1.0 million, or 9%. Service revenue represented 36% of total revenue for the six months ended June 30, 2008 and 36% of total revenue for the six months ended June 30, 2007. Growth in core engineering services revenue in both North America and Asia Pacific drove the increase due to reasons mentioned earlier plus incremental contribution from Japan in the first six months of 2008, partially offset by a decrease in rebillable revenue of $789,000. Billable hours increased by 16% for the six months ended June 30, 2008, driven by higher activity levels in both the North American and Asia Pacific regions, whereas the realized rate per hour increased by 1% for the six months ended June 30, 2008.

We currently expect service revenue to increase approximately 30% to 35% in fiscal 2008, as compared to fiscal 2007, based on our expectation that the summer slowdown that has affected us for the last two years will do so to a lesser extent in 2008, as well as growth in our sales capacity and increased revenue from the Asia Pacific region resulting from our expansion there. Further, we expect that several contracts, which either have been signed or are expected to be signed this quarter, will add significantly to service revenue in the second half of fiscal 2008.

Gross profit and gross margin

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software products, the costs of components for our hardware reference designs, product media, product duplication and manuals. Amortization of intangible assets, acquired from Vibren Technologies Inc. in June 2005 and from NEC of America in December 2007, is also included in cost of software revenue and was $22,000 for the three months ended June 30, 2008 and $48,000 for the three months ended June 30, 2007. Amortization of intangible assets included in cost of software revenue was $44,000 for the six months ended June 30, 2008 and $96,000 for the six months ended June 30, 2007. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, related facilities and depreciation costs. Gross profit on the sales of third-party software products is also positively affected by rebates and volume discounts we receive from Microsoft which we earn through the achievement of defined objectives.

Rebates comprised $90,000 of our third-party software gross profit for the three months ended June 30, 2008 and $190,000 of our gross profit for the three months ended June 30, 2007. Rebates comprised $151,000 of our gross profit for the six months ended June 30, 2008 and $348,000 of our gross profit for the six months ended June 30, 2007. These decreases were the result of changes to the rebate program, which became effective October 1, 2007. Microsoft has frequently modified its rebate program, and future modifications could have the effect of reducing, or even eliminating, the rebate credit or volume discounts we receive.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
Software gross profit	$2,005	$2,245	$4,604	$4,618
As a percentage of total software revenue	21%	22%	22%	24%
Service gross profit	$1,771	$1,262	$3,822	$2,886
As a percentage of service revenue	31%	26%	32%	27%
Total gross profit	$3,776	$3,507	$8,426	$7,504
As a percentage of total revenue	24%	23%	26%	25%

Software gross profit and gross margin

Software gross profit was $2.0 million for the three months ended June 30, 2008 and $2.2 million for the three months ended June 30, 2007, representing a decrease of $200,000, or 9%. Software gross profit as a percentage of software revenue was 21% for the three months ended June 30, 2008 and 22% for the three months ended June 30, 2007. The decrease in gross profit was due to lower, high-margin proprietary software revenue, partially offset by higher gross margin from sales of Flash Lite and Solidcore S3 Control that were not present in the comparable period in 2007. Software gross profit was $4.6 million for the six months ended June 30, 2008 and 2007. Software gross profit as a percentage of software revenue was 22% for the six months ended June 30, 2008 and 24% for the six months ended June 30, 2007 with the decrease driven by the relative mix of high-margin proprietary software revenue to our total software revenue. Our proprietary software sales have traditionally generated high gross margins (91% this quarter), while third-party software sales typically generate much lower gross margins. Third-party software margin was 16% for the three months ended June 30, 2008, compared to 14% for the same period in the prior year with the increase driven by higher margins resulting from sales of Flash Lite licensing and Solidcore S3 Control licensing.

We expect third-party software sales to continue to be a significant percentage of our software revenue, and, therefore our software gross margin will likely remain relatively low in the foreseeable future. We currently expect our proprietary software gross margin to remain at relatively high levels. We currently expect our third-party software margin to approximate our fiscal 2007 margin of 17%, with the increase driven by gross profit contribution from higher margin third-party software products such as Flash Lite and S3 Control.

Service gross profit and gross margin

Service gross profit was $1.8 million for the three months ended June 30, 2008 and $1.3 million for the three months ended June 30, 2007, representing an increase of $500,000, or 38%. Service gross profit as a percentage of service revenue was 31% for the three months ended June 30, 2008 and 26% for the three months ended June 30, 2007. Service gross profit was $3.8 million for the six months ended June 30, 2008 and $2.9 million for the six months ended June 30, 2007, representing an increase of $900,000, or 31%. Service gross profit as a percentage of service revenue was 32% for the six months ended June 30, 2008 and 27% for the six months ended June 30, 2007. The overall improvement in service gross profit is attributable to improvement in our utilization and a decline in lower margin rebillable service revenue. Our utilization declined in the second quarter of 2007 due to a slow down in North America service revenue which did not reoccur in the second quarter of 2008. Additionally, our facilities and depreciation costs, a portion of which is included in service cost of revenue, are relatively fixed and are being spread over a larger revenue base, which has the effect of increasing service gross profit as service revenue increases.

We expect service gross margin to improve in fiscal 2008, as compared to fiscal 2007, as a result of higher revenue and improved utilization. We currently expect fiscal 2008 service margin to be in the mid-30% range, compared to 29% in fiscal 2007.

Operating expenses

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and benefits 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 were $3.0 million for the three months ended June 30, 2008 and $2.7 million for the three months ended June 30, 2007, representing an increase of approximately $300,000, or 11%. These increases were due to higher sales expenses both in North America and the Asia Pacific region, higher marketing program costs and higher stock compensation expense. Selling, general and administrative expenses represented 19% of total revenue for the three months ended June 30, 2008 and 17% of total revenue for the three months ended June 30, 2007. Selling, general and administrative expenses were $6.0 million for the six months ended June 30, 2008 and $5.6 million for the six months ended June 30, 2007, representing an increase of approximately $400,000, or 7% driven by the factors mentioned previously. Selling, general and administrative expenses represented 18% of total revenue for the six months ended June 30, 2008 and 19% of total revenue for the six months ended June 30, 2007.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs, component costs and related facilities and depreciation costs.

Research and development expenses were $561,000 for the three months ended June 30, 2008 and $598,000 for the three months ended June 30, 2007, representing a decrease of $37,000, or 6%. Research and development expenses represented 4% of total revenue for the three months ended June 30, 2008 and 2007. Research and development expenses were $1.2 million for the six months ended June 30, 2008 and $1.1 million for the six months ended June 30, 2007, representing an increase of $100,000, or 9%. Research and development expenses represented 4% of total revenue for all periods presented. We continue to execute and evolve our product strategy and invest in new product development initiatives; however, the timing and magnitude of our investments are difficult to predict.

Interest and other income

Interest and other income consists of interest earnings on our cash, cash equivalents and investments. Interest and other income was $88,000 for the three months ended June 30, 2008 and $444,000 for the three months ended June 30, 2007, representing a decrease of $356,000, or 80%. Interest and other income was $248,000 for the six months ended June 30, 2008 and $567,000 for the six months ended June 30, 2007, representing a decrease of $319,000, or 56%. These decreases were due to a realized gain on the sale of marketable securities of $287,000, which benefited the three months ended June 30, 2007, coupled with lower interest rates as compared to the prior year.

Income Tax Expense

Income tax expense was $10,000 for the three months ended June 30, 2008 and $108,000 for the three months ended June 30, 2007, representing a decrease of $98,000, or 91%. Income tax expense was $127,000 for the six months ended June 30, 2008 and $148,000 for the six months ended June 30, 2007, representing a decrease of $21,000, or 14%. This expense primarily related to corporate income taxes, primarily from our Taiwan branch.

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Liquidity and Capital Resources

As of June 30, 2008, we had $16.4 million of cash, cash equivalents and investments compared to $15.0 million at December 31, 2007. These totals include $900,000 of restricted cash at June 30, 2008 and $1,050,000 at December 31, 2007. This restricted cash secures our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital at June 30, 2008 was $10.4 million compared to $14.7 million at December 31, 2007. The decrease in working capital was primarily due to the reclassification of our auction rate securities, or ARS, from short-term investments to long-term investments on our balance sheet at June 30, 2008 compared to December 31, 2007.

Our investments consist of ARS, which are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long term they are generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed). As of June 30, 2008, we had investments in auction rate securities valued $6.5 million. These investments are illiquid and we are unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is contingent on redeeming the investments by the issuers or sales of the securities in a secondary market. ARS are currently being sold on the secondary market at discounts that range from 5% to 25% depending on the type of security. The failed ARS carry AAA ratings and continue to pay interest according to the stated terms. There has been no reduction in fair value of the underlying collateral of our ARS portfolio. Although we are uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be only temporary. It is possible that declines in fair value may occur in the future. If the credit ratings of the issuer, the bond insurers or the collateral deteriorate, we may adjust the carrying value of these investments. If the current market conditions deteriorate further, we may be required to record unrealized losses in other comprehensive income or impairment charges. As of June 30, 2008, we have reclassified the balance of ARS on our balance sheet from short-term investments to long-term investments due to the uncertainty in timing of liquidating these investments.

During the six months ended June 30, 2008, operating activities provided cash of $1.6 million attributable to our net income of $1.4 million and non-cash expenses of $1.0 million, offset by certain working capital items. During the six months ended June 30, 2007, operating activities provided cash of $1.1 million attributable to our net income of $1.2 million and non-cash expenses of $725,000, offset by certain working capital items.

During the six months ended June 30, 2008, investing activities provided cash of $2.8 million of cash attributable to $3.1 million in maturities of short-term investments, , partially offset by $367,000 used to purchase capital equipment. During the six months ended June 30, 2007, investing activities utilized approximately $3.3 million of cash attributable to $3.1 million invested in short-term investments and $267,000 used to purchase capital equipment.

Financing activities generated $84,000 in cash during the six months ended June 30, 2008 and $685,000 in cash during the six months ended June 30, 2007 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 twelve months.

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Potential Cash Commitments

We have the following future or potential cash commitments:

In February 2004, we signed an amendment to the lease for our former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters. The amendment of the former headquarters lease, which was scheduled to terminate on December 31, 2004, provided that no cash lease payments were to be made for the remainder of 2004. Similarly, our corporate headquarters lease also provided that no cash lease payments were to be made during 2004. However, if we default under our new corporate headquarters lease, the landlord has the ability to demand payment for cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was $1.5 million at June 30, 2008. The amount of the forgiven payments for which the landlord has the ability to demand repayment decreases on the straight-line basis over the length of our ten-year headquarters lease.

In December 2007, we entered into an agreement with Solidcore Systems, Inc. (Solidcore) to be the exclusive distributor of Solidcore s S3 Control Embedded software to OEMs in North America. This agreement commits us to pay minimum license fees of $800,000 to Solidcore by December 31, 2008, regardless of our sales of that software provided that any prepaid licensing fees outstanding at December 31, 2008 can be used to offset future license fees owed to Solidcore through the termination of the agreement between the parties. As of June 30, 2008, we have $310,000 remaining toward this commitment. We expect licensing sales of Solidcore S3 Control to meet the minimum required threshold to cover the contractual license fee.

Recently Issued Accounting Standards

In June 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. Emerging Issues Task Force (EITF) 03-6-1 (FSP 03-6-1), *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share under the two-class method described in SFAS No. 128, *Earnings Per Share*. FSP 03-6-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008, and will require all earnings per share data presented for prior-periods to be restated retrospectively. We currently do not anticipate that FSP 03-6-1 will have a material impact on our earnings per share data for fiscal year 2009 or on earnings per share data for any prior periods presented.

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Item 4. Controls and Procedures

We carried out an evaluation required by the Securities Exchange Act of 1934, under the supervision and with the participation of our senior management, including our principal executive officer and 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 on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, are effective in timely alerting them to material information required to be included in our periodic SEC reports.

There has been no change in our internal control over financial reporting during the six months ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

IPO Litigation

In Summer and early Fall 2001, four purported shareholder class action lawsuits were filed in the United States District Court for the Southern District of New York against us, certain of our current and former officers and directors (the Individual Defendants), and the underwriters of our initial public offering (the Underwriter Defendants). The complaints were consolidated into a single action and a Consolidated Amended Complaint, which was filed on April 19, 2002, is now the operative complaint. The operative complaint alleges violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The suit purports to be a class action filed on behalf of purchasers of our common stock during the period from October 19, 1999 to December 6, 2000.

The plaintiffs allege that the Underwriter Defendants agreed to allocate stock in our initial public offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. The plaintiffs allege that the prospectus for our initial public offering was false and misleading in violation of the securities laws because we did not disclose these arrangements. The action seeks damages in an unspecified amount.

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On December 5, 2006, the Second Circuit vacated a decision by the district court granting class certification in six of the coordinated cases, which are intended to serve as test, or focus cases. The plaintiffs selected these six cases, which do not include us. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by the plaintiffs, but noted that the plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The amended complaints include a number of changes, such as changes to the definition of the purported class of investors, and the elimination of the individual defendants as defendants. On September 27, 2007, the plaintiffs moved to certify a class in the six focus cases. On November 14, 2007, the issuers and the underwriters named as defendants in the six focus cases filed motions to dismiss the amended complaints. On March 26, 2008, the district court dismissed the Securities Act claims of those members of the putative classes in the focus cases who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. With respect to all other claims, the motions to dismiss were denied. We are awaiting a decision from the Court on the class certification motion. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. If we are found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.

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Item 1A. Risk Factors

The following risk factors and other information in this quarterly report on Form 10-Q and also those discussed in our annual report on Form 10-K for the year-ended December 31, 2007 and in our quarterly report on Form 10-Q for the three months ended March 31, 2008 should be carefully considered. The risks and uncertainties described below and discussed in the aforementioned reports are not the only ones we face. 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 and cash flows could be materially adversely affected. We do not repeat risk factors that were disclosed in our most recent annual report on Form 10-K and in our quarterly report on Form 10Q for the three months ended March 31, 2008, which have not changed substantially, including financial/numerical information where such information has not changed materially or where the relationship of such information to other financial information has not changed materially. Instead, we will update risk factors where changes or updates are deemed significant and will add new risk factors not previously disclosed as they become pertinent to our business. To the extent a risk factor is no longer considered relevant that was described in our most recent annual report on Form 10-K, it will be deleted in the annual report on Form 10-K to be filed for the year ending December 31, 2008.

Microsoft-Related Risk Factors

If we do not maintain our OEM Distribution Agreement with Microsoft, our revenue would decrease and our business would be adversely affected.

We have an OEM Distribution Agreement (ODA) with Microsoft, which enables us to resell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico. Software sales under this agreement constitute a significant portion of our revenue. If the ODA was terminated, our software revenue and resulting gross profit would decrease significantly and our operating results would be negatively impacted. The ODA is renewable annually, and there is no automatic renewal provision in the agreement. The ODA was renewed effective July 1, 2008 and will expire on June 30, 2009, unless terminated earlier under the provisions of the ODA. There were no material changes to the provisions of the ODA as a result of the renewal. Future renewals, if any, could be on less favorable terms, which could negatively impact our business and operating results.

Significant changes to the Microsoft s pricing structure and rebate programs could have a negative impact on our business and operating results.

Microsoft recently communicated to its distribution partners that it will change its pricing structure and rebate programs, effective September 1, 2008 whereby Microsoft will generally increase the cost of software licenses we pay to Microsoft. While the effect of these changes is difficult to predict at this time, these changes could potentially reduce the amount of rebate we earn and reduce our software margins if we are unable to pass on the price increase to our customers. The affect of these items could negatively affect our gross profit, gross margins and profitability.

General Business-Related Risk Factors

All of our investment portfolio is invested in auction rate securities (ARS) which have faced recent market failures.

We have investments in ARS valued at $6,525,000 as of June 30, 2008 which have failed at auction. As a result, these investments are illiquid and we are unable to determine with any certainty when, or if, these investments will become liquid. Liquidity of these investments is subject to redemption of the investments by the issuers, or sales of the securities in a secondary market. The lack of liquidity in our ARS investments has adversely affected our liquidity and working capital and could affect our future ability to fund our strategic and other initiatives. It is possible that declines in fair value may occur in the future. Liquidity of these investments is contingent on redeeming the investments by the issuers or sales of the securities in a secondary market. ARS are currently being sold on the secondary market at discounts that range from 5% to 25% depending on the type of sucurity. A decline in the value of these ARS or continued lack of liquidity could result in losses and have a material negative impact on our operating results and financial condition. If the credit ratings of the issuer, the bond insurers or the collateral deteriorate, we may adjust the carrying value of

these investments. If the current market conditions deteriorate further, we may be required to record unrealized losses in other comprehensive income or impairment charges.

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

On June 4, 2008, the following matter was submitted to a vote at the Annual Meeting of Shareholders:

Proposal 1: Election of Directors. Two Class II directors were elected at our 2008 Annual Meeting for three-year terms ending in 2011 by the vote set forth below:

Nominee	Shares For	Shares Withheld
Donald B. Bibeault	5,671,811	3,585,270
Brian T. Crowley	7,208,788	2,048,343

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Item 6. Exhibits

Exhibit No.	Exhibit Description
3.1	Amended and Restated Articles of Incorporation (incorporated by reference to our registration statement on Form S-1 (File No. 333-85351) filed with the Securities and Exchange Commission on October 19, 1999)
3.1(a)	Articles of Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our quarterly report on Form 10-Q filed with the Securities and Exchange Commission on August 7, 2000)
3.1(b)	Articles of Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our current report on Form 8-K filed with the Securities and Exchange Commission on October 11, 2005)
3.2	Bylaws and all amendments thereto (incorporated by reference to our annual report on Form 10-K filed with the Securities and Exchange Commission on March 19, 2003)
31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

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: August 7, 2008

By: /s/ Brian T. Crowley

Brian T. Crowley
President and Chief Executive Officer

Date: August 7, 2008

By: /s/ Scott C. Mahan

Scott C. Mahan
Vice President, Finance and Chief Financial Officer

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BSQUARE CORPORATION
INDEX TO EXHIBITS

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