

BSQUARE CORP /WA
Form 10-Q
August 04, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2011

OR

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

For the transition period from to

Commission File Number: 000-27687

BSQUARE CORPORATION

(Exact name of registrant as specified in its charter)

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Washington
(State or other jurisdiction of
incorporation or organization)

91-1650880
(I.R.S. Employer
Identification No.)

110 110th Avenue NE, Suite 200,
Bellevue WA
(Address of principal executive offices)

98004
(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 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 July 31, 2011: 10,664,089

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BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended June 30, 2011

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(In thousands, except share amounts)

	June 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 8,510	\$ 10,814
Short-term investments	13,723	11,329
Accounts receivable, net of allowance for doubtful accounts of \$264 at June 30, 2011 and \$290 at December 31, 2010	13,393	14,128
Deferred tax assets	119	145
Prepaid expenses and other current assets	780	403
Total current assets	36,525	36,819
Long-term investment	116	122
Equipment, furniture and leasehold improvements, net	759	653
Intangible assets, net	882	1,049
Restricted cash	875	875
Deferred tax assets	2,376	2,495
Other non-current assets	94	83
Total assets	\$ 41,627	\$ 42,096
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Third-party software fees payable	\$ 9,121	\$ 11,132
Accounts payable	372	261
Accrued compensation	2,207	2,497
Other accrued expenses	1,701	1,467
Deferred revenue	1,516	1,417
Total current liabilities	14,917	16,774
Deferred rent	205	240
Shareholders' equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 10,638,964 shares issued and outstanding at June 30, 2011 and 10,415,541 shares issued and outstanding at December 31, 2010	126,032	124,716
Accumulated other comprehensive loss	(543)	(445)
Accumulated deficit	(98,984)	(99,189)
Total shareholders' equity	26,505	25,082
Total liabilities and shareholders' equity	\$ 41,627	\$ 42,096

See notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenue:				
Software	\$ 17,059	\$ 17,246	\$ 35,808	\$ 29,258
Service	6,363	9,659	13,622	14,592
Total revenue	23,422	26,905	49,430	43,850
Cost of revenue:				
Software	13,108	14,032	28,377	23,677
Service	5,207	5,097	10,696	11,215
Total cost of revenue	18,315	19,129	39,073	34,892
Gross profit	5,107	7,776	10,357	8,958
Operating expenses:				
Selling, general and administrative	4,108	2,981	8,039	6,117
Research and development	985	802	1,899	1,709
Total operating expenses	5,093	3,783	9,938	7,826
Income from operations	14	3,993	419	1,132
Other income (expense)	34	(5)	42	(493)
Income before income taxes	48	3,988	461	639
Income tax expense	(27)	(15)	(256)	(106)
Net income	\$ 21	\$ 3,973	\$ 205	\$ 533
Basic income per share	\$ 0.00	\$ 0.39	\$ 0.02	\$ 0.05
Diluted income per share	\$ 0.00	\$ 0.39	\$ 0.02	\$ 0.05
Shares used in calculation of income per share:				
Basic	10,563	10,157	10,497	10,142
Diluted	11,529	10,287	11,657	10,268

See notes to condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net income	\$ 205	\$ 533
Adjustments to reconcile net income to net cash used by operating activities:		
Realized loss (gain) on investments	(19)	546
Depreciation and amortization	402	475
Stock-based compensation	1,107	278
Deferred income tax benefit	145	
Changes in operating assets and liabilities:		
Accounts receivable, net	741	(7,586)
Prepaid expenses and other assets	(385)	163
Third-party software fees payable	(2,011)	4,589
Accounts payable and accrued expenses	53	(132)
Deferred revenue	95	650
Deferred rent	(35)	(35)
Net cash provided by (used in) operating activities	298	(519)
Cash flows from investing activities:		
Purchases of equipment and furniture	(339)	(72)
Proceeds from maturities of short-term investments	9,675	1,000
Proceeds from sale of auction rate securities	25	516
Proceeds from reduction of restricted cash		25
Purchases of short-term investments	(12,064)	(6,404)
Net cash used in investing activities	(2,703)	(4,935)
Cash flows from financing activities - proceeds from exercise of stock options	209	36
Effect of exchange rate changes on cash	(108)	(23)
Net decrease in cash and cash equivalents	(2,304)	(5,441)
Cash and cash equivalents, beginning of period	10,814	12,918
Cash and cash equivalents, end of period	\$ 8,510	\$ 7,477

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2011

(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 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 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 June 30, 2011 and our operating results and cash flows for the three and six months ended June 30, 2011 and 2010. The accompanying financial information as of December 31, 2010 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained our Annual Report on Form 10-K for the year ended December 31, 2010. All intercompany balances have been eliminated.

Reclassification of Previously Issued Financial Statements

We have reclassified certain current liabilities in our condensed consolidated statement of cash flows for the six months ended June 30, 2010 related to fees payable to third-party software suppliers such as Microsoft Corporation (**Microsoft**) given the significance of such fees. These fees were previously included in accounts payable and other accrued expenses, and are now listed as third-party software fees payable.

Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board, or FASB, issued guidance regarding the presentation of comprehensive income. The new standard requires the presentation of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The new standard also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented. The updated guidance is effective on a retrospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The adoption of this guidance will not have a material impact on our financial statements.

In May 2011, the FASB issued additional guidance on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. The updated guidance is effective on a prospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The adoption of this guidance will not have a material impact on our financial statements.

Income or Loss Per Share

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

Table of Contents**2. Investments**

Investments consist of the following (in thousands):

	June 30, 2011	December 31, 2010
Short-term investments:		
U.S. agency securities	751	2,250
Municipal securities	451	450
Corporate commercial paper	4,500	2,749
Foreign government bonds	775	775
Corporate debt securities	7,246	5,105
Total short-term investments	13,723	11,329
Long-term investment auction rate security (ARS)	116	122
Total investments	\$ 13,839	\$ 11,451

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

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

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

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

Our short-term investments consist entirely of marketable securities classified as available for sale, and were valued based on quoted market prices of similar instruments and other significant Level 2 inputs derived from, or corroborated by, observable market data. As of June 30, 2011 and December 31, 2010 our marketable securities consisted primarily of corporate debt, U.S. and foreign government and agency securities. Such amounts are recorded at fair value.

Our long-term investment consists entirely of a single ARS issuance, and was recorded at fair value using Level 3 inputs at June 30, 2011 and December 31, 2010. Due to the lack of observable market quotes on our ARS, we have estimated the fair value using inputs including the underlying financial condition and credit quality of the issuer, the maturity of the security, and secondary market bid levels of similar and identical securities.

On March 31, 2010, we reached a decision to liquidate our ARS. This liquidation of ARS primarily occurred during the remainder of 2010. Prior to March 31, 2010, it was assumed that the ARS would be held until they were redeemed at full par value by the issuers, or until the underwriters and/or secondary offerors settled. As we no longer believed that we were to realize full par value from our ARS portfolio, the carrying value of our ARS was adjusted downward by \$924,000 as of June 30, 2010, which was deemed to be an other-than-temporary adjustment. Of this amount, \$378,000 was deemed to be other than-temporary during 2008, and therefore a further downward adjustment of \$546,000 was recorded as a charge to other income (expense) during the six months ended June 30, 2010.

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Based on Level 3 inputs, we estimated the fair value of our ARS to be \$116,000 as of June 30, 2011, compared to a par value of \$475,000. We have classified our ARS as a long-term investment as of June 30, 2011 due to our uncertainty as to when this security will be sold. During the six months ended June 30, 2011, we sold \$25,000 of our ARS at par value, and recognized a \$19,000 gain on the sale.

We had \$1,000 of unrealized losses on our short-term investments as of both June 30, 2010, and December 31, 2010.

3. Intangible Assets

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

	June 30, 2011	December 31, 2010
Gross carrying value of the acquired intangible assets subject to amortization	\$ 2,158	\$ 2,158
Accumulated amortization	(1,276)	(1,109)
Net book value	\$ 882	\$ 1,049

As of June 30, 2011, 83% of the gross carrying value and 74% of the net book value represented acquired technology. Amortization expense was \$83,000 and \$167,000 for the three and six months ended June 30, 2011, respectively, and \$128,000 and \$256,000 for the three and six months ended June 30, 2010 respectively. Amortization in future periods is expected to be as follows (in thousands):

Remainder of 2011	\$ 167
2012	330
2013	278
2014	37
2015	36
Thereafter	34
Total	\$ 882

4. Shareholders Equity**Stock Options**

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

Table of Contents**Stock-Based Compensation**

The estimated fair value of stock-based awards is recognized as compensation expense over the vesting period of the award, net of estimated forfeitures. We estimate forfeitures based on historical experience and expected future activity. The fair values of RSAs and RSUs are determined based on the number of shares granted and the quoted price of our common stock on the date of grant, less our estimation of future forfeitures. 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 equity awards, primarily stock option grants, were estimated with the following weighted average assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	74%	72%	74%	71%
Risk-free interest rate	1.3%	1.8%	1.5%	1.9%

The impact on our results of operations of recording stock-based compensation expense for the three and six months ended June 30, 2011 and 2010 was as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Cost of revenue service	\$ 157	\$ 46	\$ 376	\$ 119
Selling, general and administrative	415	62	654	140
Research and development	35	10	77	19
Total stock-based compensation expense	\$ 607	\$ 118	\$ 1,107	\$ 278
Per diluted share	\$ 0.05	\$ 0.01	\$ 0.09	\$ 0.03

Stock Option Activity

The following table summarizes stock option activity for the six months ended June 30, 2011:

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Balance at January 1, 2011	1,942,723	\$ 3.66		
Granted at fair value	384,640	8.15		
Exercised	(141,617)	2.94		
Forfeited	(20,436)	3.13		
Expired	(5,212)	31.81		

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Balance at June 30, 2011	2,160,098	\$ 4.44	4.89	\$ 4,962,000
Vested and expected to vest at June 30, 2011	2,042,126	\$ 4.35	4.80	\$ 4,808,000
Exercisable at June 30, 2011	1,467,373	\$ 3.87	4.11	\$ 3,842,000

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At June 30, 2011, total compensation cost related to stock options granted to employees but not yet recognized was \$1,294,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.67 years.

The following table summarizes certain information about stock options for the three and six months ended June 30, 2011 and 2010:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Weighted-average grant-date fair value of option grants for the period	\$ 3.99	\$ 1.62	\$ 4.61	1.60
Options in-the-money at period end	1,365,882	249,164	1,365,882	249,164
Aggregate intrinsic value of options exercised	\$ 209,000	\$ 5,000	\$ 751,000	\$ 7,000

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

Restricted Stock Award Activity

The following table summarizes RSA activity for the six months ended June 30, 2011:

	Number of Shares	Weighted Average Grant-Date Fair Value Per Share
Unvested at December 31, 2010	42,000	\$ 3.38
Granted	21,000	7.33
Vested	(27,000)	3.26
Forfeited		
Unvested at June 30, 2011	36,000	\$ 5.78
Expected to vest after June 30, 2011	32,040	\$ 5.78

At June 30, 2011, total compensation cost related to RSAs granted but not yet recognized was \$110,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 0.5 years. Currently, only non-employee members of our Board of Directors receive restricted RSAs.

Restricted Stock Unit Activity

The following table summarizes RSU activity for the six months ended June 30, 2011:

Number of Shares	Weighted Average Grant Date Fair
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			Value
Unvested at December 31, 2010	346,776	\$	4.47
Granted	21,966		8.87
Vested	(77,979)		3.30
Forfeited	(16,549)		4.86
Unvested at June 30, 2011	274,214	\$	5.13
Expected to vest after June 30, 2011	255,235	\$	5.13

At June 30, 2011, total compensation cost related to RSUs granted but not yet recognized was \$743,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.0 year.

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The following table summarizes our shares of common stock reserved for future issuance at June 30, 2011:

	June 30, 2011
Stock options outstanding	2,160,098
Restricted stock units outstanding	274,214
Stock options available for future grant	388,461
Common stock reserved for future issuance	2,822,773

5. Other Comprehensive Income or Loss

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net unrealized gain on investments	\$ 6	\$	\$ 5	\$ 308
Foreign currency translation loss	(61)	(20)	(103)	(19)
Other comprehensive income (loss)	\$ (55)	\$ (20)	\$ (98)	\$ 289

6. Commitments and Contingencies

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

If we default under the terms of our corporate headquarters' lease in Bellevue, Washington, signed in February 2004, the landlord has the ability to demand payment for cash payments forgiven in 2004. The amount of the forgiven payments for which the landlord can demand repayment was \$759,000 at June 30, 2011.

Rent expense was \$385,000 and \$767,000 for the three and six months ended June 30, 2011, respectively. Rent expense was \$395,000 and \$789,000 for the three and six months ended June 30, 2010, respectively.

As of June 30, 2011, we had \$875,000 pledged as collateral for a bank letter of credit under the terms of our headquarters' facility lease. The pledged cash supporting the outstanding letter of credit is recorded as restricted cash.

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

2011	\$ 685
2012	1,200

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2013	1,089
2014	770
Thereafter	
Total commitments	\$ 3,744

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.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Total revenue:				
North America	\$ 18,347	\$ 22,922	\$ 37,703	\$ 38,356
Asia	4,368	3,505	10,050	4,635
Other foreign	707	478	1,677	859
Total revenue	\$ 23,422	\$ 26,905	\$ 49,430	\$ 43,850

&