

BSQUARE CORP /WA
Form 10-Q
November 14, 2012
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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 September 30, 2012

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

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

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 October 31, 2012: 11,056,577

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BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended September 30, 2012

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

(In thousands, except share amounts)

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 6,897 | \$ 8,505 |
| Short-term investments | 11,782 | 9,619 |
| Accounts receivable, net of allowance for doubtful accounts of \$234 at September 30, 2012 and \$311 at December 31, 2011 | 16,586 | 13,403 |
| Deferred tax assets | 797 | 520 |
| Prepaid expenses and other current assets | 910 | 1,281 |
| Total current assets | 36,972 | 33,328 |
| Equipment, furniture and leasehold improvements, net | 879 | 1,037 |
| Intangible assets, net | 1,129 | 1,390 |
| Restricted cash | 875 | 875 |
| Deferred tax assets | 1,611 | 2,302 |
| Goodwill | 3,738 | 3,738 |
| Other non-current assets | 128 | 122 |
| Total assets | \$ 45,332 | \$ 42,792 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Third-party software fees payable | \$ 10,763 | \$ 8,460 |
| Accounts payable | 202 | 695 |
| Accrued compensation | 1,956 | 2,645 |
| Other accrued expenses and liabilities | 2,490 | 2,330 |
| Deferred revenue | 1,568 | 1,233 |
| Total current liabilities | 16,979 | 15,363 |
| Deferred rent | 171 | 184 |
| Long-term tax liability | 211 | 210 |
| Shareholders' equity: | | |
| Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding | | |
| Common stock, no par value: 37,500,000 shares authorized; 11,022,992 shares issued and outstanding at September 30, 2012 and 10,874,050 shares issued and outstanding at December 31, 2011 | | |
| | 128,123 | 127,318 |
| Accumulated other comprehensive loss | (720) | (631) |
| Accumulated deficit | (99,432) | (99,652) |
| Total shareholders' equity | 27,971 | 27,035 |

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| | | | | |
|--|----|--------|----|--------|
| Total liabilities and shareholders' equity | \$ | 45,332 | \$ | 42,792 |
|--|----|--------|----|--------|

See notes to condensed consolidated financial statements.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|------------------|--|----------------|
| | 2012 | 2011 | 2012 | 2011 |
| Revenue: | | | | |
| Software | \$ 19,635 | \$ 17,021 | \$ 55,645 | \$ 52,829 |
| Service | 5,850 | 7,008 | 19,893 | 20,630 |
| Total revenue | 25,485 | 24,029 | 75,538 | 73,459 |
| Cost of revenue: | | | | |
| Software | 15,730 | 13,856 | 45,094 | 42,233 |
| Service | 4,913 | 5,369 | 16,410 | 16,065 |
| Total cost of revenue | 20,643 | 19,225 | 61,504 | 58,298 |
| Gross profit | 4,842 | 4,804 | 14,034 | 15,161 |
| Operating expenses: | | | | |
| Selling, general and administrative | 2,866 | 4,332 | 10,557 | 12,371 |
| Research and development | 861 | 950 | 2,909 | 2,849 |
| Total operating expenses | 3,727 | 5,282 | 13,466 | 15,220 |
| Income (loss) from operations | 1,115 | (478) | 568 | (59) |
| Other income, net | 28 | 43 | 122 | 85 |
| Income (loss) before income taxes | 1,143 | (435) | 690 | 26 |
| Income tax benefit (expense) | (533) | 269 | (470) | 13 |
| Net income (loss) | \$ 610 | \$ (166) | \$ 220 | \$ 39 |
| Basic income (loss) per share | \$ 0.06 | \$ (0.02) | \$ 0.02 | \$ 0.00 |
| Diluted income (loss) per share | \$ 0.05 | \$ (0.02) | \$ 0.02 | \$ 0.00 |
| Shares used in calculation of income (loss) per share: | | | | |
| Basic | 10,943 | 10,610 | 10,935 | 10,578 |
| Diluted | 11,474 | 10,610 | 11,450 | 11,780 |
| Comprehensive income (loss): | | | | |
| Net income (loss) | \$ 610 | \$ (166) | \$ 220 | \$ 39 |
| Other comprehensive income (expense): | | | | |
| Foreign currency translation, net of tax | (65) | (40) | (75) | (106) |
| Change in unrealized gains on investments, net of tax | 6 | (8) | 18 | (5) |

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| | | | | |
|--|--------|----------|--------|---------|
| Total other comprehensive income (expense) | (59) | (48) | (57) | (111) |
| Comprehensive income (loss) | \$ 551 | \$ (214) | \$ 163 | \$ (72) |

See notes to condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|--|-----------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 220 | \$ 39 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Realized gain on investments | | (19) |
| Depreciation and amortization | 758 | 599 |
| Stock-based compensation | 685 | 1,685 |
| Deferred income tax expense | 415 | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (3,176) | (1,264) |
| Prepaid expenses and other assets | 367 | (612) |
| Third-party software fees payable | 2,303 | (1,031) |
| Accounts payable and accrued expenses | (1,076) | (585) |
| Deferred revenue | 331 | (437) |
| Deferred rent | (13) | (53) |
| Net cash provided by (used in) operating activities | 814 | (1,678) |
| Cash flows from investing activities: | | |
| Purchases of equipment and furniture | (336) | (528) |
| Acquisition of business, less acquired cash | | (3,362) |
| Proceeds from maturities of short-term investments | 8,400 | 17,944 |
| Purchases of short-term investments | (10,535) | (14,274) |
| Proceeds from sale of auction rate securities | | 25 |
| Net cash used in investing activities | (2,471) | (195) |
| Cash flows from financing activities | | |
| proceeds from exercise of stock options | 193 | 281 |
| Effect of exchange rate changes on cash | (144) | (169) |
| Net decrease in cash and cash equivalents | (1,608) | (1,761) |
| Cash and cash equivalents, beginning of period | 8,505 | 10,814 |
| Cash and cash equivalents, end of period | \$ 6,897 | \$ 9,053 |
| Supplemental disclosures of cash flow information: | | |
| Contingent consideration for acquisition of business | \$ | \$ 810 |
| Accrued payment for acquisition of business | \$ | \$ 1,425 |

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of BSQUARE Corporation (**BSQUARE**) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (**SEC**) for interim financial reporting and include the accounts of BSQUARE and our wholly owned subsidiaries. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (**GAAP**) have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of September 30, 2012 and our operating results and cash flows for the three and nine months ended September 30, 2012 and 2011. The accompanying financial information as of December 31, 2011 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011. All intercompany balances have been eliminated.

Recently Issued Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (**FASB**) issued an accounting standard update that amends the accounting guidance on testing indefinite-lived intangible assets for impairment. The amendments in this accounting standard update are intended to reduce complexity and costs by allowing an entity the option to make a qualitative evaluation about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment, which is equivalent to the impairment testing requirements for other long-lived assets. The amendments in this accounting standard update are effective for interim and annual impairment tests performed for fiscal years beginning after September 15, 2012. The adoption is not expected to impact our financial position or results of operations.

Income (Loss) Per Share

Basic income or loss per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as options, restricted stock awards and restricted stock units. Restricted stock awards (**RSAs**) are considered outstanding and included in the computation of basic income or loss per share when underlying restrictions expire and the awards are no longer forfeitable. Restricted stock units (**RSUs**), which vest over a period of one to four years, are considered outstanding and included in the computation of basic income or loss per share only when vested. Diluted income per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock method. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive. Unvested but outstanding RSUs and RSAs which are forfeitable are included in the diluted income per share calculation. In a period where we are in a net loss position, the diluted loss per share is computed using the basic share count.

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Cash, cash equivalents, short-term investments, and restricted cash consisted of the following at September 30, 2012 and December 31, 2011 (in thousands):

| | September 30, 2012 | December 31, 2011 |
|--|-----------------------|----------------------|
| Cash | \$ 2,022 | \$ 1,428 |
| Cash equivalents: | | |
| Corporate debt | 450 | 501 |
| Money market funds | 4,425 | 6,576 |
| Total cash equivalents | 4,875 | 7,077 |
| Total cash and cash equivalents | 6,897 | 8,505 |
| Short-term investments: | | |
| U.S. agency securities | | 1,751 |
| Municipal securities | 355 | 355 |
| Corporate commercial paper | 5,373 | 1,250 |
| Foreign government bonds | | 500 |
| Corporate debt | 6,054 | 5,763 |
| Total short-term investments | 11,782 | 9,619 |
| Restricted cash money market fund | 875 | 875 |
| Total cash, cash equivalents, investments and restricted cash | \$ 19,554 | \$ 18,999 |

Gross unrealized gains and losses on our short-term investments were not material as of September 30, 2012 and December 31, 2011. Our restricted cash balance at September 30, 2012 and December 31, 2011 relates to a letter of credit which will continue to secure our corporate headquarter lease obligation to its expiration in 2014.

3. Fair Value Measurements

We measure our cash equivalents, marketable securities, and the earn-out liability associated with our acquisition of MPC Data Limited (MPC) (see Note 4) at fair value. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. A three-tier fair value hierarchy is established as a basis for considering such assumptions and for inputs used in the valuation methodologies in measuring fair value:

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

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

Level 3: Unobservable inputs that are not corroborated by market data. The inputs require significant management judgment or estimation. We classify our cash equivalents and marketable securities within Level 1 or Level 2 because our cash equivalents and marketable securities are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs. We classify our earn-out liability associated with MPC within Level 3 as it is valued using inputs such as management's estimation of future sales.

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Assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011 are summarized below (in thousands):

| | September 30, 2012 | | | Total |
|--|---|---|--|------------------|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Assets | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 4,425 | \$ | \$ | \$ 4,425 |
| Corporate debt | | 450 | | 450 |
| Total cash equivalents | 4,425 | 450 | | 4,875 |
| Short-term investments: | | | | |
| Municipal securities | | 355 | | 355 |
| Corporate commercial paper | | 5,373 | | 5,373 |
| Corporate debt | | 6,054 | | 6,054 |
| Total short-term investments | | 11,782 | | 11,782 |
| Restricted cash money market fund | 875 | | | 875 |
| Total assets measured at fair value | \$ 5,300 | \$ 12,232 | \$ | \$ 17,532 |
| MPC earn-out liability | \$ | \$ | \$ 632 | \$ 632 |

| | December 31, 2011 | | | Total |
|--|---|---|--|------------------|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Assets | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 6,576 | \$ | \$ | \$ 6,576 |
| Corporate debt | | 501 | | 501 |
| Total cash equivalents | 6,576 | 501 | | 7,077 |
| Short-term investments: | | | | |
| U.S. agency securities | | 1,751 | | 1,751 |
| Municipal securities | | 355 | | 355 |
| Corporate commercial paper | | 1,250 | | 1,250 |
| Foreign government bonds | | 500 | | 500 |
| Corporate debt | | 5,763 | | 5,763 |
| Total short-term investments | | 9,619 | \$ | 9,619 |
| Restricted cash money market fund | 875 | | | 875 |
| Total assets measured at fair value | \$ 7,451 | \$ 10,120 | \$ | \$ 17,571 |

| | | | | | | |
|------------------------|----|----|----|-----|----|-----|
| MPC earn-out liability | \$ | \$ | \$ | 766 | \$ | 766 |
|------------------------|----|----|----|-----|----|-----|

4. Acquisition

On September 11, 2011, we completed the acquisition of MPC, a United Kingdom based provider of embedded software engineering services.

We acquired all outstanding shares of MPC preferred and common stock in exchange for total consideration of \$7.1 million, which included an earn-out. The earn-out is re-measured to estimated fair value each reporting period based on specific revenue earned and forecasted in designated regions of Europe through September 30, 2012. This earn-out had an estimated fair value of \$810,000 as of the acquisition date and \$632,000 as of September 30, 2012, which will be paid in the fourth quarter of 2012. We also acquired \$1.5 million in cash and cash equivalents as part of the acquisition, for a net estimated total cash price of \$5.5 million.

The business combination was accounted for using the acquisition method of accounting, which requires an acquirer to recognize the assets acquired and liabilities assumed at the acquisition date measured at their fair values, including intangible assets acquired consisting of trade names and trademarks, non-compete agreements, and customer relationships. The acquisition of MPC was structured as a stock purchase and therefore the values assigned to the intangible assets and goodwill are not deductible for tax purposes. Deferred tax liabilities of \$233,000 were recognized as part of the transaction. The excess

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of the acquisition consideration, including the initial estimated fair value of the earn-out, over the fair value of net assets acquired was recorded as goodwill. Our allocation of the acquisition consideration to the assets acquired and liabilities assumed as of the date of the acquisition is as follows (in thousands):

| | |
|--|--------------|
| Acquisition consideration | \$ 7,038 |
| Net assets acquired: | |
| Cash and cash equivalents | 1,481 |
| Other current assets | 1,124 |
| Property, equipment, and furniture | 103 |
| Intangible assets customer relationships | 973 |
| Intangible assets non-compete agreements | 206 |
| Intangible assets trade names and trademarks | 96 |
| Current liabilities | (473) |
| Long-term tax liabilities | (210) |
| Net assets acquired | 3,300 |
| Goodwill | \$ 3,738 |

Of the intangible assets acquired, customer relationships had a weighted-average useful life of 10 years, non-compete agreements had a weighted-average useful life of two years, and trade names and trademarks had a weighted-average useful life of one year. We assessed the fair value of the earn-out associated with the acquisition each period using Level 3 inputs represented by management's estimation of future applicable engineering service revenue attributable to MPC through September 30, 2012. Changes to the estimated fair value of the earn-out have been recognized as other income (expense), net in the period in which the changes occur.

Unaudited Pro Forma Results of Operations

Unaudited pro forma results of operations are being furnished solely for informational purposes and are not intended to represent or be indicative of the consolidated results of operations that we would have reported had the MPC acquisition been completed as of the dates and for the periods presented, nor are they necessarily indicative of future results.

The unaudited pro forma results of operations data are derived from the consolidated financial statements of MPC and include pro forma adjustments relating to the MPC acquisition that are of a recurring nature representing pro forma amortization of intangible assets. The pro forma results were adjusted to assume all of the acquisition expenses directly related to MPC were incurred on January 1, 2011, and do not give effect to any cost savings, revenue synergies, integration or restructuring costs which may result from the MPC operations (in thousands, except per share amounts):

| | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2011 |
|-----------------------------------|--|---|
| Net sales | \$ 25,266 | \$ 77,254 |
| Gross profit | 5,415 | 16,828 |
| Income (loss) from operations | 21 | (81) |
| Income (loss) before income taxes | 161 | (10) |
| Net income (loss) | 450 | 16 |
| Basic income per share | 0.04 | 0.00 |
| Diluted income per share | \$ 0.04 | \$ 0.00 |

5. Goodwill and Intangible Assets

There was no change in the carrying amount of goodwill during the nine months ended September 30, 2012.

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

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Information regarding our intangible assets as of September 30, 2012 and December 31, 2011 is as follows (in thousands):

| | September 30, 2012 | | |
|----------------------------|-----------------------------|-----------------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Trade names and trademarks | \$ 180 | \$ 178 | \$ 2 |
| Customer relationships | 1,275 | 243 | 1,032 |
| Non-compete agreements | 196 | 101 | 95 |
| Total | \$ 1,651 | \$ 522 | \$ 1,129 |

| | December 31, 2011 | | |
|----------------------------|-----------------------------|-----------------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Trade names and trademarks | \$ 180 | \$ 92 | \$ 88 |
| Customer relationships | 1,275 | 141 | 1,134 |
| Non-compete agreements | 196 | 28 | 168 |
| Total | \$ 1,651 | \$ 261 | \$ 1,390 |

Amortization expense was \$85,000 and \$261,000 for the three and nine months ended September 30, 2012, respectively, and \$92,000 and \$259,000 for the three and nine months ended September 30, 2011, respectively. Amortization in future periods is expected to be as follows (in thousands):

| | |
|-------------------|----------|
| Remainder of 2012 | \$ 60 |
| 2013 | 206 |
| 2014 | 135 |
| 2015 | 135 |
| 2016 | 130 |
| Thereafter | 463 |
| Total | \$ 1,129 |

6. Shareholders' Equity**Stock Options**

We have a Fourth Amended and Restated Stock Plan (the "Stock Plan") and an inducement stock plan for newly hired employees (the "Inducement Plan") (collectively, the "Plans"). Under the Plans, stock options may be granted with a fixed exercise price that is equivalent to fair market value on the date of grant. These options have a term of up to 10 years and vest over a predetermined period, generally four years. Incentive stock options granted under the Stock Plan may only be granted to our employees. The Plans also allow for awards of non-qualified stock options, stock appreciation rights, RSAs and unrestricted stock awards, and RSUs. The Inducement Plan was established in connection with the MPC acquisition. Initially, 250,000 shares were allocated for award under the Inducement Plan. The number of shares available for award under the Inducement Plan may be modified by our Board of Directors, subject to SEC and NASDAQ limitations.

Stock-Based Compensation

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

| | Three Months Ended | | Nine Months Ended | |
|-------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Dividend yield | 0% | 0% | 0% | 0% |
| Expected life | 4 years | 4 years | 4 years | 4 years |
| Expected volatility | 73% | 73% | 73% | 74% |
| Risk-free interest rate | 0.5% | 0.8% | 0.6% | 1.2% |

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The impact on our results of operations of recording stock-based compensation expense for the three and nine months ended September 30, 2012 and 2011 was as follows (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Cost of revenue service | \$ 34 | \$ 184 | \$ 242 | \$ 560 |
| Selling, general and administrative | (267) | 346 | 355 | 1,000 |
| Research and development | 26 | 48 | 89 | 125 |
| Total stock-based compensation expense | \$ (207) | \$ 578 | \$ 686 | \$ 1,685 |
| Per diluted share | \$ (0.02) | \$ 0.05 | \$ 0.06 | \$ 0.14 |

Stock Option Activity

The following table summarizes stock option activity under the Plans for the nine months ended September 30, 2012:

| Stock Options | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|---|---------------------|--|---|---------------------------------|
| Balance at January 1, 2012 | 1,939,475 | \$ 4.49 | | |
| Granted at fair value | 164,875 | 3.44 | | |
| Exercised | (82,424) | 2.43 | | |
| Forfeited | (309,932) | 6.85 | | |
| Expired | (85,627) | 7.06 | | |
| Balance at September 30, 2012 | 1,626,367 | \$ 3.90 | 4.12 | \$ 485,000 |
| Vested and expected to vest at September 30, 2012 | 1,581,671 | \$ 3.90 | 3.99 | \$ 482,000 |
| Exercisable at September 30, 2012 | 1,319,717 | \$ 3.90 | 3.06 | \$ 448,000 |

At September 30, 2012, total compensation cost related to stock options granted to employees but not yet recognized was \$341,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately two years.

The following table summarizes certain information about stock options for the three and nine months ended September 30, 2012 and 2011:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Weighted-average grant-date fair value of option grants for the period | \$ | \$ 3.67 | \$ 2.23 | \$ 4.52 |
| Options in-the-money at period end | 616,350 | 1,040,047 | 616,350 | 1,040,047 |

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| | | | | |
|--|-----------|------------|-----------|------------|
| Aggregate intrinsic value of options exercised | \$ 34,000 | \$ 119,000 | \$ 67,000 | \$ 871,000 |
|--|-----------|------------|-----------|------------|

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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 nine months ended September 30, 2012:

| | Number of Shares | Weighted Average Grant-Date Fair Value Per Share |
|---|---------------------|--|
| Unvested at December 31, 2011 | 27,000 | \$ 6.49 |
| Granted | | |
| Vested | (27,000) | 6.49 |
| Forfeited | | |
| Unvested at September 30, 2012 | 0 | \$ 0.00 |
| Expected to vest after September 30, 2012 | 0 | \$ 0.00 |

At September 30, 2012, total compensation cost related to RSAs granted but not yet recognized was \$0, net of estimated forfeitures.

Restricted Stock Unit Activity

The following table summarizes RSU activity for the nine months ended September 30, 2012:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---------------------|--|
| Unvested at December 31, 2011 | 241,248 | \$ 6.20 |
| Granted | 177,592 | 3.49 |
| Vested | (95,103) | 4.97 |
| Forfeited | (26,019) | 6.28 |
| Unvested at September 30, 2012 | 297,718 | \$ 4.97 |
| Expected to vest after September 30, 2012 | 268,879 | \$ 4.88 |

At September 30, 2012, total compensation cost related to RSUs granted but not yet recognized was \$980,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 2.1 years.

Common Stock Reserved for Future Issuance

The following table summarizes our shares of common stock reserved for future issuance under the Plans at September 30, 2012:

September 30,
2012

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| | |
|---|-----------|
| Stock options outstanding | 1,626,367 |
| Restricted stock units outstanding | 297,718 |
| Stock options available for future grant | 1,071,447 |
| Common stock reserved for future issuance | 2,995,532 |

7. Commitments and Contingencies

Lease and rent obligations

Our commitments include obligations outstanding under operating leases, which expire through 2018. We have lease commitments for office space in Bellevue, Washington; San Diego, California; Taipei, Taiwan; Beijing, China; Seoul, Korea; Nishi-Shinjuku, Japan; Munich, Germany; and Trowbridge, UK. We also lease office space on a month-to-month basis in Akron, Ohio.

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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 \$459,000 at September 30, 2012.

Rent expense was \$455,000 and \$1.4 million for the three and nine months ended September 30, 2012, respectively. Rent expense was \$401,000 and \$1.2 million for the three and nine months ended September 30, 2011, respectively.

As of September 30, 2012, 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 classified as restricted cash.

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

| | |
|--------------------------|-----------------|
| Remainder of 2012 | \$ 422 |
| 2013 | 1,384 |
| 2014 | 1,046 |
| 2015 | 273 |
| 2016 | 273 |
| Thereafter | 243 |
| Total commitments | \$ 3,641 |

Volume Pricing Agreements

In conjunction with our activities under the OEM Distribution Agreements (ODAs) with Microsoft, as further described in Note 9, we enter into OEM Volume Royalty Pricing (OVRP) commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don t meet the committed minimum unit volumes, we are obligated to pay the difference between the committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather, the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. However, in the event a customer is unwilling or unable to pay us, we would be negatively impacted. Based upon the credit-worthiness of our customers, our historical OVRP experience with our customers and OVRP arrangements in general, we do not believe we will incur any material liability in the current or future periods

8. Information about Geographic Areas

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

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

| | Three Months Ended | | Nine Months Ended | |
|----------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Total revenue: | | | | |
| North America | \$ 16,382 | \$ 19,197 | \$ 52,145 | \$ 56,900 |
| Asia | 7,733 | 3,449 | 18,951 | 13,499 |

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| | | | | |
|---------------|-----------|-----------|-----------|-----------|
| Europe | 1,365 | 1,348 | 4,409 | 2,981 |
| Other foreign | 5 | 35 | 33 | 79 |
| Total revenue | \$ 25,485 | \$ 24,029 | \$ 75,538 | \$ 73,459 |

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| | September 30, 2012 | December 31, 2011 |
|--------------------------------|-----------------------|----------------------|
| Long-lived assets: | | |
| North America | \$ 3,340 | \$ 4,334 |
| Asia | 230 | 111 |
| Europe | 4,791 | 5,019 |
| Total long-lived assets | \$ 8,361 | \$ 9,464 |

9. Significant Risk Concentrations*Significant Customer*

No customer accounted for 10% or more of total revenue for the three or nine months ended September 30, 2012. Ford Motor Company (Ford) accounted for \$2.5 million, or 11% of total revenue, for the three months ended September 30, 2011 and \$7.2 million, or 10% of total revenue, for the nine months ended September 30, 2011.

No customer accounted for 10% or more of total accounts receivable as of September 30, 2012 or December 31, 2011.

Significant Supplier

We have OEM Distribution Agreements (ODAs) with Microsoft Corporation (Microsoft) which enable us to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba), Mexico, the European Union and the European Free Trade Association, which expire on June 30, 2013. We also have ODAs with Microsoft which allow us to sell Microsoft Windows Mobile operating systems in the Americas, Japan, Taiwan, Europe, the Middle East, and Africa which will expire on December 31, 2012 or January 31, 2013, depending on the territory.

Software sales under these agreements constitute a significant portion of our software revenue and total revenue. These agreements are typically renewed annually or semi-annually; however, there is no automatic renewal provision in any of these agreements. Further, these agreements can be terminated unilaterally by Microsoft at any time. Microsoft currently offers a rebate program to sell Microsoft Windows Embedded operating systems pursuant to which we earn money for achieving certain predefined objectives. Under this rebate program we earned \$196,000 and \$609,000 during the three and nine months ended September 30, 2012, respectively, and \$212,000 and \$555,000 during the three and nine months ended September 30, 2011, respectively. These rebates are accounted for as a reduction in software cost of revenue.

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

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our condensed consolidated financial statements and related notes. Some statements and information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended, (the Exchange Act). In some cases, readers can identify forward-looking statements by terms such as may, will, should, expect, intend, forecast, anticipate, believe, estimate, predict, potential, continue, or the negative of these terms or other comparable terminology when used are meant to signify the statement as forward-looking. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and situations that are difficult to predict and that may cause our own, or our industry's actual results, to be materially different from the future results that are expressed or implied by these statements. Accordingly, actual results may differ materially from those anticipated or expressed in such statements as a result of a variety of factors, including those discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011 entitled Risk Factors, as well as those contained from time to time in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

Overview

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

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

Critical Accounting Judgments

Management's discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales, cost of sales and expenses and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There have been no significant changes to our critical accounting policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2011.

Results of Operations

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

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| | Three Months Ended September 30, 2012 2011 (unaudited) | | Nine Months Ended September 30, 2012 2011 (unaudited) | |
|-------------------------------------|--|------|---|-----|
| Revenue: | | | | |
| Software | 77% | 71% | 74% | 72% |
| Service | 23 | 29 | 26 | 28 |
| | | | | |
| Total revenue | 100 | 100 | 100 | 100 |
| Cost of revenue: | | | | |
| Software | 62 | 58 | 59 | 57 |
| Service | 19 | 22 | 22 | 22 |
| | | | | |
| Total cost of revenue | 81 | 80 | 81 | 79 |
| | | | | |
| Gross profit | 19 | 20 | 19 | 21 |
| Operating expenses: | | | | |
| Selling, general and administrative | 11 | 18 | 14 | 17 |
| Research and development | 4 | 4 | 4 | 4 |
| | | | | |
| Total operating expenses | 15 | 22 | 18 | 21 |
| | | | | |
| Income (loss) from operations | 4 | (2) | 0 | 0 |
| Other income, net | 0 | 0 | 0 | 0 |
| | | | | |
| Income (loss) before income taxes | 4 | (2) | 0 | 0 |
| Income tax benefit (expense) | (2) | 1 | 0 | 0 |
| | | | | |
| Net income (loss) | 2% | (1)% | 0% | 0% |

Table of Contents**Revenue**

Our revenue is generated from the sale of software, both our own proprietary software and software of third parties that we resell, and the sale of engineering services. Total revenue increased \$1.5 million, or 6%, to \$25.5 million for the three months ended September 30, 2012, from \$24.0 million in the year-ago period. Total revenue increased \$2.1 million, or 3%, to \$75.5 million for the nine months ended September 30, 2012, from \$73.5 million in the year-ago period. These increases were driven by higher sales of Microsoft Windows Embedded operating systems.

In September 2011, we acquired the operations of MPC Data Limited (MPC) in the United Kingdom. The MPC acquisition positively impacted service revenue as seen by the \$733,000 and \$2.9 million increases to European service revenue for the three and nine months ended September 30, 2012, respectively, compared to the respective year-ago periods. Additionally, sales to Asia increased \$4.3 million and \$5.5 million during the three and nine months ended September 30, 2012, respectively, compared to the respective year-ago periods, primarily due to increased engineering services revenue from new customers in Japan.

Software revenue

Software revenue consists of sales of third-party software and revenue realized from our own proprietary software products, which include software license sales, royalties from our software products, and support and maintenance revenue. Software revenue for the three and nine months ended September 30, 2012 and 2011 was as follows (dollars in thousands):

| | Three Months Ended September 30, 2012 2011 (unaudited) | | Nine Months Ended September 30, 2012 2011 (unaudited) | |
|--|--|-----------|---|-----------|
| Software revenue: | | | | |
| Third-party software | \$ 18,339 | \$ 15,593 | \$ 52,424 | \$ 48,259 |
| Proprietary software | 1,296 | 1,428 | 3,221 | 4,570 |
| Total software revenue | \$ 19,635 | \$ 17,021 | \$ 55,645 | \$ 52,829 |
| Software revenue as a percentage of total revenue | 77% | 71% | 74% | 72% |
| Third-party software revenue as a percentage of total software revenue | 93% | 92% | 94% | 91% |

The vast majority of our third-party software revenue is comprised of sales of Microsoft Windows Embedded and Windows Mobile operating systems. Third-party software revenue increased \$2.7 million, or 18%, for the three months ended September 30, 2012, from the year-ago period. The increase was due primarily to a \$1.5 million increase in sales of Windows Mobile operating systems which, in turn, was primarily driven by a large sale to a customer in Korea. Microsoft Windows Embedded operating system sales also increased \$621,000 for the three months ended September 30, 2012, compared to the year-ago period, which was spread across all customer segments.

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Third-party software revenue increased \$4.2 million, or 9%, for the nine months ended September 30, 2012, compared to the year-ago period, driven primarily by increased sales of Microsoft Windows General Embedded operating systems across all customer segments, as well as a \$1.2 million increase in Qualcomm Snapdragon devkit sales which were classified as proprietary software revenue in the year-ago period, and which are now classified as third-party software revenue.

Proprietary software revenue decreased \$132,000, or 9%, to \$1.3 million for the three months ended September 30, 2012, from \$1.4 million in the year-ago period. This decrease was driven by the reclassification of Snapdragon devkit sales which were classified as proprietary software revenue in the year-ago period, and which are now classified as third-party software revenue as described above. Of this amount, \$525,000 in Snapdragon devkit sales were classified as proprietary software revenue in the year-ago period compared to \$455,000 which are classified as third-party software revenue in the current quarter. This decrease was offset by \$462,000 in sales of our new HTML5 Rendering Engine software in this current quarter.

Proprietary software revenue decreased \$1.3 million, or 30%, to \$3.2 million for the nine months ended September 30, 2012, from \$4.6 million in the year-ago period, driven by the same factors that accounted for the three-month decrease as well as a decline in our Open Multimedia Applications Platform (OMAP) revenue.

Service revenue

Service revenue for the three months ended September 30, 2012 and 2011 was as follows (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2012 (unaudited) | 2011 (unaudited) | 2012 (unaudited) | 2011 (unaudited) |
| Service revenue | \$ 5,850 | \$ 7,008 | \$ 19,893 | \$ 20,630 |
| Service revenue as a percentage of total revenue | 23% | 29% | 26% | 28% |

Service revenue decreased \$1.2 million, or 17%, for the three months ended September 30, 2012, from the year-ago period. This decrease was primarily due to a \$1.9 million decline in North American service revenue driven by an \$874,000 decrease associated with the MyFord Touch program and the loss of a major customer that contributed in the year-ago quarter. The North American decline was offset in part by the full quarter effect of the MPC acquisition which occurred in September 2011 whereby we saw a \$733,000 increase in European service revenue.

Service revenue decreased \$737,000, or 4%, for the nine months ended September 30, 2012 compared to the year-ago period. This decrease was primarily due to a \$4.8 million decline in North American service revenue driven by a \$2.1 million decrease associated with the MyFord Touch as well as two other significant customers. This decline was offset in part by a \$2.9 million increase in European service revenue resulting from the MPC acquisition and a \$1.7 million increase in service revenue in Japan driven by a significant new customer in Japan.

Microsoft Corporation (Microsoft) became our largest engineering services customer during the first quarter of this year, replacing Ford Motor Company (Ford), as Microsoft replaced Ford as the invoiced customer on the MyFord Touch program. We continue to work on the MyFord Touch, a project we began with Ford during the second quarter of 2008; however, we now conduct these services through an agreement with Microsoft. During the initial project with Ford, we provided hardware design and implementation, platform level software development, application level software development, quality assurance services and systems integration services. The project has transitioned since the initial project such that we are now primarily focused on developing and integrating new user applications for the MyFord Touch, enhancing existing applications and customizing the MyFord Touch platform for additional vehicle models. Service revenue from the MyFord Touch program declined \$874,000 to \$1.7 million, or 28% of total service revenue, for the three months ended September 30, 2012, compared to \$2.5 million, or 36% of total service revenue, in the year-ago period. Service revenue from the MyFord Touch program declined \$2.1 million to \$5.1 million, or 26% of total service revenue, for the nine months ended September 30, 2012, compared to \$7.2 million, or 35% of total service revenue, in the year-ago period. The declines are primarily attributable to a reduction in the number of engineers working on the MyFord Touch project.

Gross profit and gross margin

Cost of software revenue consists primarily of the cost of third-party software products payable to third-party vendors and support costs associated with our proprietary software products. Cost of service revenue consists primarily of salaries and benefits, contractor costs and

re-billable expenses, related facilities and depreciation costs, and amortization of certain

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intangible assets related to acquisitions. Gross profit on the sale of third-party software products is also positively affected by rebate credits we receive from Microsoft for the sale of Windows Embedded operating systems earned through the achievement of defined objectives and treated as a reduction in the cost of software revenue. Under this rebate program we earned \$196,000 and \$609,000 for the three and nine months ended September 30, 2012, respectively, compared to \$212,000 and \$555,000 for the three and nine months ended September 30, 2011, respectively.

Gross profit and related gross margin for the three and nine months ended September 30, 2012 and 2011 were as follows (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------|-------------------------------------|----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (unaudited) | | (unaudited) | |
| Software gross profit | \$ 3,905 | \$ 3,165 | \$ 10,551 | \$ 10,596 |
| Software gross margin | 20% | 19% | 19% | 20% |
| Service gross profit | \$ 937 | \$ 1,639 | \$ 3,483 | \$ 4,565 |
| Service gross margin | 16% | 23% | 18% | 22% |
| Total gross profit | \$ 4,842 | \$ 4,804 | \$ 14,034 | \$ 15,161 |
| Total gross margin | 19% | 20% | 19% | 21% |

Software gross profit and gross margin

Software gross profit increased by \$740,000, or 23%, for the three months ended September 30, 2012, from the year-ago period, while software gross margin improved by one percentage point. The improvement to gross profit was primarily the result of higher third-party software sales while the gross margin improvement was largely the result of a one percentage point increase in third-party software gross margin. Third-party software gross margin was 16% for the three months ended September 30, 2012, compared to 15% in the year-ago period. Proprietary software gross margin was 80% for the three months ended September 30, 2012, compared to 62% in the year-ago period, with the increase driven by higher revenue.

Software gross profit was \$10.6 million for both the nine months ended September 30, 2012 and the year-ago period while software gross margin declined by one percentage point. The decrease in software gross margin was due to a \$1.3 million decline in higher margin proprietary software revenue.

Service gross profit and gross margin

Service gross profit decreased \$702,000, or 43%, to \$937,000 for the three months ended September 30, 2012, from \$1.6 million in the year-ago period. Service gross margin decreased by seven percentage points to 16% for the three months ended September 30, 2012, compared to 23% in the year-ago period. The decline in service gross profit was primarily driven by a \$1.2 million decline in service revenue. The gross margin decline primarily resulted from a 10% reduction in our realized rate per hour, while our cost per billable hour remained relatively flat.

Service gross profit decreased \$1.1 million, or 24%, to \$3.5 million for the nine months ended September 30, 2012, from \$4.6 million in the year-ago period. Service gross margin was 18% for the nine months ended September 30, 2012, a four percentage point decrease from 22% in the year-ago period. These declines were driven by the same factors that accounted for the three-month decrease although the realized rate per hour only declined by 3%.

Operating expenses**Selling, general and administrative**

Selling, general and administrative expenses consist primarily of salaries and related benefits, commissions for our sales teams, marketing and administrative personnel and related facilities and depreciation costs, as well as professional services fees (e.g., consulting, legal, tax and audit). Selling, general and administrative expenses decreased \$1.5 million, or 34%, to \$2.9 million for the three months ended September 30, 2012, from \$4.3 million in the year-ago period. This decrease was due primarily to a reduction in selling expense. Domestic and international sales staff reductions and a stock-based compensation expense adjustment for the departure of our Vice President Sales contributed to the sales expense decrease. In total, including the effect of the Vice President Sales departure, stock compensation expense decreased \$622,000 for the three months ended September 30, 2012 compared to the year-ago period. This decrease was due to a reduction in sales expense due to net reductions in our sales teams both domestically and internationally. Selling, general and administrative expenses represented 11% of our total

revenue for the three months ended September 30, 2012 and 18% in the year-ago period.

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Selling, general and administrative expenses decreased \$1.8 million, or 15%, to \$10.6 million for the nine months ended September 30, 2012, from \$12.4 million in the year-ago period. This decrease was driven by the same factors that accounted for the three-month decrease. Selling, general and administrative expenses represented 14% of our total revenue for the nine months ended September 30, 2012 and 17% for the year-ago period.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs and related facilities and depreciation costs. Research and development expenses decreased \$89,000, or 9%, to \$861,000 for the three months ended September 30, 2012, from \$950,000 in the year-ago period due primarily to headcount reductions and an office closure which took place toward the end of the third quarter of 2012. Research and development expenses represented 3% of our total revenue for the three months ended September 30, 2012 and 4% in the year-ago period.

Research and development expenses increased \$60,000, or 2%, to \$2.9 million for the nine months ended September 30, 2012, from \$2.8 million in the year-ago period. This increase was driven by development efforts associated with a new initiative with Texas Instruments earlier in the year which was completed in the third quarter of 2012. Research and development expenses represented 4% of our total revenue for the nine months ended September 30, 2012 and 4% for the year-ago period.

Other income, net

Other income consists of interest income on our cash, cash equivalents and investments, gains and/or losses recognized on our investments, changes in the estimated fair value of acquisition-related contingent consideration, as well as gains or losses on foreign exchange transactions. Other income decreased \$15,000, or 35%, to \$28,000 for the three months ended September 30, 2012, from \$43,000 in the year-ago period.

Other income increased \$37,000, or 44%, to \$122,000 for the nine months ended September 30, 2012, from \$85,000 in the year-ago period.

Income tax benefit (expense)

Income tax expense was \$533,000 for the three months ended September 30, 2012, compared to an income tax benefit of \$269,000 in the year-ago period, a change of \$803,000. Income tax expense was \$470,000 for the nine months ended September 30, 2012, compared to an income tax benefit of \$13,000 in the year-ago period, a change of \$483,000. The effective tax rate of 68% for the nine months ended September 30, 2012 was primarily the result of year-to-date losses in our China subsidiary which began operation in 2012. The losses for this subsidiary do not flow through for U.S. federal income tax purposes and we are unable to recognize any tax benefit at this time. The benefit of these losses will be offset by a valuation allowance until it is likely that the losses will be utilizable in the future. The effective tax rate for the nine months ended September 30, 2012 would be 43% excluding the impact of China and a discrete tax benefit recorded in the first quarter of 2012 related to the release of additional valuation allowance on U.S. deferred assets.

Liquidity and Capital Resources

As of September 30, 2012, we had \$19.5 million of cash, cash equivalents, short-term and long-term investments and restricted cash, compared to \$19.0 million at December 31, 2011. Of these amounts, \$6.9 million and \$8.5 million were classified as cash and cash equivalents at September 30, 2012 and December 31, 2011, respectively, and \$875,000 was classified as long-term at both September 30, 2012 and December 31, 2011.

Net cash generated by operating activities was \$814,000 for the nine months ended September 30, 2012, driven by non-cash expenses of \$2.4 million offset in part by net negative working capital changes. Net cash used in operating activities was \$1.7 million for the nine months ended September 30, 2011, driven by net negative changes in our working capital, offset in part by \$2.3 million in non-cash charges.

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Investing activities used cash of \$2.5 million for the nine months ended September 30, 2012, due primarily to net purchases of short-term investments of \$2.1 million and \$336,000 in equipment purchases. Investing activities used cash of \$195,000 for the nine months ended September 30, 2011, primarily due to the acquisition of MPC which resulted in \$3.4 million of cash payments, net of the cash acquired in the transaction. This amount was largely offset by net maturities of our marketable securities of \$3.7 million.

Financing activities generated \$193,000 during the nine months ended September 30, 2012, and \$281,000 during the nine months ended September 30, 2011, as a result of employees' exercise of stock options.

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

Cash Commitments

We have the following future or potential cash commitments:

Minimum rents payable under operating leases total \$422,000 for the remainder of 2012, \$1.4 million in 2013, \$1.0 million in 2014, \$273,000 in 2015, \$273,000 in 2016 and \$243,000 thereafter;

Under the terms of our corporate headquarters lease signed in February 2004, the landlord has the ability to demand payment for cash payments forgiven in 2004 if we default under the lease. The amount of the forgiven payments for which the landlord can demand repayment was \$459,000 at September 30, 2012; and

Under the terms of the Share Purchase Agreement for MPC, we will pay an earn-out to the sellers of MPC in the fourth quarter of 2012. The amount of this payment will be \$632,000. See Note 4, Acquisition of the Notes to Condensed Consolidated Financial Statements in Item 1 for further discussion of this amount.

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

Recently Issued Accounting Standards

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4. Controls and Procedures

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

There were no changes to our disclosure controls during the three months ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

There has been no material change in the risk factors set forth in Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011 other than the following:

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

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

Item 6. Exhibits

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

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SIGNATURES

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

BSQUARE CORPORATION
(Registrant)

Date: November 14, 2012

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

President and Chief Executive Officer

Date: November 14, 2012

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

Senior Vice President, Operations and Chief Financial Officer

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

| Exhibit Number | Description | Filed | | | | |
|-------------------|---|--------------|------|--|---------|-----------|
| | | Here with | Form | Incorporated by Reference Filing Date | Exhibit | File No. |
| 3.1 | Amended and Restated Articles of Incorporation | | S-1 | 8/17/1999 | 3.1(a) | 333-85351 |
| 3.1(a) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 10-Q | 8/7/2000 | 3.1 | 000-27687 |
| 3.1(b) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 8-K | 10/11/2005 | 3.1 | 000-27687 |
| 3.2 | Bylaws and all amendments thereto | | 10-K | 3/19/2003 | 3.2 | 000-27687 |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 | X | | | | |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 | X | | | | |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | | |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | | |
| 101.INS* | XBRL Instance Document | X | | | | |
| 101.SCH* | XBRL Taxonomy Extension Schema | X | | | | |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase | X | | | | |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase | X | | | | |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase | X | | | | |

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.