

BSQUARE CORP /WA  
Form 10-Q  
August 09, 2007

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

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2007**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 000-27687**

**BSQUARE CORPORATION**

(Exact name of registrant as specified in its charter)

**Washington**

(State or other jurisdiction of  
incorporation or organization)

**91-1650880**

(I.R.S. Employer  
Identification No.)

**110 110<sup>th</sup> 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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, 2007: 9,890,030

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**BSQUARE CORPORATION**  
**FORM 10-Q**  
**For the Quarterly Period Ended June 30, 2007**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**BSQUARE CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(dollars in thousands)

|   | <b>June 30,<br/>2007<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2006</b> |
|---|--|----------------------------------|
| <b>ASSETS</b>   |  |                                  |
| Current assets:   |  |                                  |
| Cash and cash equivalents   | \$ 1,011                                 | \$ 2,483                         |
| Short-term investments  | 10,344                                   | 7,426                            |
| Accounts receivable, net of allowance for doubtful accounts of \$198 at June 30, 2007 and \$198 at December 31, 2006  | 9,478                                    | 7,167                            |
| Prepaid expenses and other current assets   | 358                                      | 421                              |
| Total current assets  | 21,191                                   | 17,497                           |
| Equipment, furniture and leasehold improvements, net  | 894                                      | 821                              |
| Intangible assets, net  |  | 101                              |
| Restricted cash   | 1,050                                    | 1,200                            |
| Other non-current assets  | 56                                       | 57                               |
| Total assets  | \$ 23,191                                | \$ 19,676                        |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |  |                                  |
| Current liabilities:  |  |                                  |
| Accounts payable  | \$ 2,766                                 | \$ 2,634                         |
| Other accrued expenses  | 4,010                                    | 2,877                            |
| Accrued compensation  | 1,199                                    | 1,046                            |
| Accrued legal fees  | 534                                      | 534                              |
| Deferred revenue  | 206                                      | 154                              |
| Total current liabilities   | 8,715                                    | 7,245                            |
| Deferred rent   | 343                                      | 355                              |
| Commitments and contingencies (Note 5)  |  |                                  |
| 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; 9,887,808 shares issued and outstanding at June 30, 2007 and 9,617,755 shares issued and outstanding at December 31, 2006 | 120,345                                  | 119,229                          |
| Accumulated other comprehensive loss  | (419)                                    | (180)                            |
| Accumulated deficit   | (105,793)                                | (106,973)                        |

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|  |           |           |
|--|-----------|-----------|
| Total shareholders' equity                 | 14,133    | 12,076    |
| Total liabilities and shareholders' equity | \$ 23,191 | \$ 19,676 |

See notes to condensed consolidated financial statements.

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**BSQUARE CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(Unaudited)

|   | <b>Three Months</b>   |             | <b>Six Months</b>     |             |
|---|-----------------------|-------------|-----------------------|-------------|
|   | <b>Ended June 30,</b> |             | <b>Ended June 30,</b> |             |
|   | <b>2007</b>           | <b>2006</b> | <b>2007</b>           | <b>2006</b> |
| Revenue:  |                       |             |                       |             |
| Software  | \$ 10,182             | \$ 9,045    | \$ 19,377             | \$ 16,900   |
| Service   | 4,912                 | 3,600       | 10,813                | 7,329       |
| Total revenue                                       | 15,094                | 12,645      | 30,190                | 24,229      |
| Cost of revenue:                                    |                       |             |                       |             |
| Software  | 7,937                 | 7,058       | 14,759                | 13,534      |
| Service <sup>(1)</sup>                              | 3,650                 | 2,580       | 7,927                 | 5,371       |
| Total cost of revenue                               | 11,587                | 9,638       | 22,686                | 18,905      |
| Gross profit  | 3,507                 | 3,007       | 7,504                 | 5,324       |
| Operating expenses:                                 |                       |             |                       |             |
| Selling, general and administrative <sup>(1)</sup>  | 2,703                 | 2,512       | 5,600                 | 5,024       |
| Research and development <sup>(1)</sup>             | 598                   | 672         | 1,143                 | 1,413       |
| Total operating expenses                            | 3,301                 | 3,184       | 6,743                 | 6,437       |
| Income (loss) from operations                       | 206                   | (177)       | 761                   | (1,113)     |
| Interest and other income                           | 444                   | 115         | 567                   | 202         |
| Income (loss) before income taxes                   | 650                   | (62)        | 1,328                 | (911)       |
| Income tax expense                                  | (108)                 | (26)        | (148)                 | (26)        |
| Net income (loss)                                   | \$ 542                | \$ (88)     | \$ 1,180              | \$ (937)    |
| Basic income (loss) per share                       | \$ 0.06               | \$ (0.01)   | \$ 0.12               | \$ (0.10)   |
| Diluted income (loss) per share                     | \$ 0.05               | \$ (0.01)   | \$ 0.12               | \$ (0.10)   |
| Shares used in calculation income (loss) per share: |                       |             |                       |             |
| Basic   | 9,823                 | 9,586       | 9,750                 | 9,575       |
| Diluted   | 10,190                | 9,586       | 10,010                | 9,575       |

(1) Includes the following

amounts related  
to non-cash  
stock-based  
compensation  
expense:

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Cost of revenue service                | \$ 60  | \$ 42  | \$ 108 | \$ 82  |
| Selling, general and administrative    | 170    | 115    | 290    | 212    |
| Research and development               | 12     | 18     | 33     | 35     |
| Total stock-based compensation expense | \$ 242 | \$ 175 | \$ 431 | \$ 329 |

See notes to condensed consolidated financial statements.

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

|   | <b>Six Months Ended</b> |              |
|---|-------------------------|--------------|
|   | <b>June 30,</b>         |              |
|   | <b>2007</b>             | <b>2006</b>  |
| Cash flows from operating activities:   |                         |              |
| Net income (loss)   | \$ 1,180                | \$ (937)     |
| Adjustments to reconcile net loss to net cash provided by operating activities: |                         |              |
| Depreciation and amortization   | 294                     | 255          |
| Stock-based compensation  | 431                     | 329          |
| Changes in operating assets and liabilities:                                    |                         |              |
| Accounts receivable, net  | (2,323)                 | 516          |
| Prepaid expenses and other assets   | 65                      | 59           |
| Accounts payable and accrued expenses   | 1,419                   | 205          |
| Deferred revenue  | 54                      | (48)         |
| Deferred rent   | (12)                    | (12)         |
| <br>Net cash provided by operating activities                                   | <br>1,108               | <br>367      |
| Cash flows from investing activities:   |                         |              |
| Purchases of equipment and furniture  | (267)                   | (169)        |
| Reduction of restricted cash  | 150                     |              |
| Purchases of short-term investments, net  | (3,144)                 | (4,200)      |
| <br>Net cash used in investing activities                                       | <br>(3,261)             | <br>(4,369)  |
| Cash flows from financing activities:   |                         |              |
| Proceeds from exercise of stock options   | 685                     | 69           |
| <br>Net cash provided by financing activities                                   | <br>685                 | <br>69       |
| <br>Effect of exchange rate changes on cash                                     | <br>(4)                 | <br>10       |
| <br>Net decrease in cash and cash equivalents                                   | <br>(1,472)             | <br>(3,923)  |
| Cash and cash equivalents, beginning of period                                  | 2,483                   | 7,694        |
| <br>Cash and cash equivalents, end of period                                    | <br>\$ 1,011            | <br>\$ 3,771 |

See notes to condensed consolidated financial statements.



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**BSQUARE CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2007**  
**(unaudited)**

**1. Summary of Significant Accounting Policies***Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements have been prepared by BSQUARE Corporation (the Company or BSQUARE ) pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) for interim financial reporting and include the accounts of the Company and its subsidiaries. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited financial statements reflect all material adjustments, which consist solely of normal recurring adjustments, necessary to present fairly the Company s financial position as of June 30, 2007 and its operating results and cash flows for the three and six months ended June 30, 2007 and 2006. The accompanying financial information as of December 31, 2006 is derived from audited financial statements. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provision for bad debts and income taxes and estimates of progress on professional service arrangements. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this quarterly report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained in the Company s annual report on Form 10-K for the year ended December 31, 2006 filed with the SEC. All intercompany balances have been eliminated.

*Earnings Per Share*

Basic earnings per share is computed by dividing net income or loss by the weighted average number of shares outstanding during the period. Basic earnings per share is computed using the weighted average number of common shares outstanding during the period excluding any dilutive effects of common stock equivalent shares, such as options and warrants. Diluted earnings per share is computed using the weighted average number of common shares outstanding during the period plus the weighted average number of common stock equivalent shares outstanding during the period (using the treasury stock method.) Common stock equivalent shares are excluded from the computation if their effect is antidilutive. The Company excluded 1,084,735 common stock equivalent shares at June 30, 2007 and 1,042,958 at June 30, 2006 from the computation since their effect is antidilutive.

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

|  | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Weighted average shares outstanding for basic earnings per share   | 9,823                     | 9,586       | 9,750                   | 9,575       |
| Dilutive effect of common stock equivalent shares                  | 367                       |             | 260                     |             |
| Weighted average shares outstanding for diluted earnings per share | 10,190                    | 9,586       | 10,010                  | 9,575       |

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Intangible assets related to technology acquired from Vibren in June 2005. They were fully amortized as of June 30, 2007.

Amortization expense was \$51,000 for the three months ended June 30, 2007 and \$101,000 for six months ended June 30, 2007. Amortization expense was \$51,000 for the three months ended June 30, 2006 and \$101,000 for the six months ended June 30, 2006.

**3. Stock-Based Compensation*****Stock Options***

In May 1997, the Company adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan ). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board, not to be less than 85% of the fair market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under the Amended Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of the Company's stock. The Amended Plan was amended in 2003 to allow for an automatic annual increase in the number of shares reserved for issuance during each of the Company's fiscal years by an amount equal to the lesser of (i) four percent of the Company's outstanding shares at the end of the previous fiscal year, (ii) an amount determined by the Company's Board of Directors, or (iii) 375,000 shares. The Amended Plan was further amended in 2005 to allow for awards of stock appreciation rights and restricted and unrestricted stock.

In July 2000, the Company adopted the 2000 Non-Qualified Stock Option Plan (the 2000 Plan ). Under the 2000 Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board. These stock options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years.

***Stock-Based Compensation***

Effective January 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to January 1, 2006, the Company accounted for stock options according to the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*, and therefore no related compensation expense was recorded for awards granted with no intrinsic value. The Company adopted the modified prospective transition method provided for under SFAS 123R and consequently has not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: 1) compensation cost related to the remaining unvested portion of all stock option awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and 2) compensation cost related to all stock option awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company records expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

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Stock-based compensation expense was recorded in the statements of operations in the same line items as cash compensation for our employees as follows (in thousands):

|                                     | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|-------------------------------------|--------------------------------|--------|------------------------------|--------|
|                                     | 2007                           | 2006   | 2007                         | 2006   |
| Cost of revenue service             | \$ 60                          | \$ 42  | \$ 108                       | \$ 82  |
| Selling, general and administrative | 170                            | 115    | 290                          | 212    |
| Research and development            | 12                             | 18     | 33                           | 35     |
| Total stock-compensation expense    | \$ 242                         | \$ 175 | \$ 431                       | \$ 329 |

Stock-based compensation expense under SFAS123R reduced net income by \$242,000 and basic and diluted earnings per share by \$0.02 for the three months ended June 30, 2007 and increased net loss by \$175,000 and loss per share by \$0.02 for the three months ended June 30, 2006.

Stock-based compensation expense under SFAS123R reduced net income by \$431,000 and basic and diluted earnings per share by \$0.05 for the six months ended June 30, 2007 and increased net loss by \$329,000 and loss per share by \$0.04 for the six months ended June 30, 2006.

At June 30, 2007, the total compensation cost related to stock options granted under the Company's stock option plans but not yet recognized was \$613,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

**Key Assumptions**

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

|                         | Three Months Ended<br>June 30, |       | Six Months Ended<br>June 30, |       |
|-------------------------|--------------------------------|-------|------------------------------|-------|
|                         | 2007                           | 2006  | 2007                         | 2006  |
| Dividend yield          | 0%                             | 0%    | 0%                           | 0%    |
|                         | 4                              | 4     | 4                            | 4     |
| Expected life           | years                          | years | years                        | years |
| Expected volatility     | 86%                            | 94%   | 86%                          | 95%   |
| Risk-free interest rate | 4.7%                           | 5.0%  | 4.7%                         | 4.9%  |
| Estimated forfeitures   | 34%                            | 36%   | 34%                          | 37%   |

*Expected Dividend* The dividend yield is determined by dividing the expected per share dividend during the coming year by the grant date stock price. The expected dividend assumption is based on the Company's current expectations about its anticipated dividend policy.

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

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

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

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

**Stock Option Activity**

The following table summarizes activity under the Company's stock option plans for the six months ended June 30, 2007:

| <b>Stock Options</b>                         | <b>Number<br/>of Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life (in<br/>years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|--|-----------------------------|--|---|--|
| Outstanding at January 1, 2007               | 1,988,280                   | \$ 3.96  |   |  |
| Granted at fair value                        | 278,200                     | 4.63   |   |  |
| Exercised                                    | (270,053)                   | 2.54   |   |  |
| Forfeited                                    | (54,287)                    | 3.39   |   |  |
| Expired                                      | (22,477)                    | 7.11   |   |  |
| Outstanding at June 30, 2007                 | 1,919,663                   | \$ 4.24  | 7.77  | \$ 4,766,000                             |
| Vested and expected to vest at June 30, 2007 | 1,556,462                   | \$ 4.49  | 0.37  | \$ 3,782,000                             |
| Exercisable at June 30, 2007                 | 994,343                     | \$ 5.27  | 6.81  | \$ 3,224,000                             |

The weighted-average grant-date fair value was \$3.65 per share for options granted during the three months ended June 30, 2007 and \$1.93 per share for options granted during the three months ended June 30, 2006. The weighted-average grant-date fair value was \$3.31 per share for options granted during the six months ended June 30, 2007 and \$2.23 per share for options granted during the six months ended June 30, 2006.

The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of the Company's common stock for the number of options that were in-the-money at June 30, 2007. There were 834,928 options that were in-the-money at June 30, 2007 and 201,422 at June 30, 2006. The Company issues new shares of common stock upon exercise of stock options. The aggregate intrinsic value of options exercised under the Company's stock option plans was approximately \$264,000 for the three months ended June 30, 2007 and \$7,000 for the three months ended June 30, 2006. The aggregate intrinsic value of options exercised under the Company's stock option plans was approximately \$627,000 for the six months ended June 30, 2007 and \$40,000 for the six months ended June 30, 2006.

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Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. The difference between net income (loss) and comprehensive income (loss) for the Company is attributable to unrealized losses on available-for-sale securities and foreign currency translation adjustments.

Components of comprehensive income (loss) consist of the following (in thousands):

|  | <b>Three Months</b>   |             | <b>Six Months</b>     |             |
|--|-----------------------|-------------|-----------------------|-------------|
|  | <b>Ended June 30,</b> |             | <b>Ended June 30,</b> |             |
|  | <b>2007</b>           | <b>2006</b> | <b>2007</b>           | <b>2006</b> |
| Net income (loss)                                | \$ 542                | \$ (88)     | \$ 1,180              | \$ (937)    |
| Unrealized loss on available-for-sale securities | (348)                 |             | (226)                 |             |
| Foreign currency translation gain (loss)         | (1)                   | (2)         | (13)                  | 15          |
| Comprehensive income (loss)                      | \$ 193                | \$ (90)     | \$ 941                | \$ (922)    |

**5. Taxes**

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109, effective January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Adoption of Interpretation 48 did not have a significant impact on the Company's financial position or results of operations.

Income tax expense was \$108,000 for the three months ended June 30, 2007 and \$26,000 for the three months ended June 30, 2006. Income tax expense was \$148,000 for the six months ended June 30, 2007 and \$26,000 for the six months ended June 30, 2006. This expense relates to corporate income taxes generated by our Taiwan subsidiary.

**6. Commitments and Contingencies*****Contractual Commitments***

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

In February 2004, the Company signed an amendment to the lease for its former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters. If the Company defaults under its corporate headquarters lease, the landlord has the ability to demand repayment for certain cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand

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repayment was \$1.7 million at June 30, 2007, which decreases on the straight-line basis over the length of the ten-year headquarters lease.

Rent expense was \$270,000 for the three months ended June 30, 2007 and \$255,000 for the three months ended June 30, 2006. Rent expense was \$542,000 for the six months ended June 30, 2007 and \$508,000 for the six months ended June 30, 2006.

As of June 30, 2007, the Company had \$1,050,000 pledged as collateral for a bank letter of credit under the terms of its headquarters facility lease. The pledged cash supporting the outstanding letter of credit is recorded as restricted cash.

Contractual commitments at June 30, 2007 were as follows (in thousands):

|                   |          |
|-------------------|----------|
| Operating leases: |          |
| Remainder of 2007 | \$ 513   |
| 2008              | 953      |
| 2009              | 853      |
| 2010              | 926      |
| 2011              | 975      |
| Thereafter        | 2,889    |
| Total commitments | \$ 7,109 |

***Legal Proceedings*****IPO Litigation**

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

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

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On July 15, 2002, the Company moved to dismiss all claims against it and the Individual Defendants. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the district court denied the motion to dismiss the complaint against the Company. On October 13, 2004, the district court certified a class in six of the approximately 300 other nearly identical actions (the focus cases) and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants appealed this decision and the Second Circuit vacated the district court's decision granting class certification in the six focus cases on December 5, 2006. Plaintiffs filed a petition for rehearing. On January 5, 2007, the Second Circuit denied the petition, but noted that Plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

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Prior to the Second Circuit's ruling, the majority of the issuers, including the Company, and their insurers had submitted a settlement agreement to the district court for approval. In light of the Second Circuit opinion, the parties agreed that the settlement could no longer be approved because the settlement class, like the litigation class, cannot be certified. On June 25, 2007, the district court approved a stipulation filed by the plaintiffs and the issuers which terminated the proposed settlement. The plaintiffs now plan to replead their complaints and move for class certification again. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit's mandate, nor can we predict the amount of any such settlement and whether that amount would be greater than the Company's insurance coverage. There is no assurance that the district court will grant final approval to the issuers' settlement. If the Company is found liable, the Company is unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company's insurance coverage, and whether such damages would have a material impact on the Company's results of operations or financial condition in any future period.

**7. Segment Information**

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

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

|                              | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|------------------------------|---------------------------|-------------|-------------------------|-------------|
|                              | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|                              | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Total revenue:               |                           |             |                         |             |
| North America                | \$ 14,137                 | \$ 11,643   | \$ 28,452               | \$ 22,701   |
| Asia                         | 944                       | 980         | 1,713                   | 1,486       |
| Other foreign                | 13                        | 22          | 25                      | 42          |
| Total revenue <sup>(1)</sup> | \$ 15,094                 | \$ 12,645   | \$ 30,190               | \$ 24,229   |

|                         | <b>June 30,</b> |  | <b>December</b> |        |
|-------------------------|-----------------|--|-----------------|--------|
|                         | <b>2007</b>     |  | <b>31,</b>      |        |
|                         |                 |  | <b>2006</b>     |        |
| Long-lived assets:      |                 |  |                 |        |
| North America           |                 |  | \$ 852          | \$ 877 |
| Asia                    |                 |  | 42              | 45     |
| Total long-lived assets |                 |  | \$ 894          | \$ 922 |

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

**Significant Customers**

As of June 30, 2007, one customer had an accounts receivable balance of approximately \$1.5 million, or 15% of total accounts receivable, which was collected in full on August 6, 2007. There were no other customers that accounted for at least 10% of total accounts receivable as of June 30, 2007 and no customers that accounted for at least 10% of total accounts receivable as of June 30, 2006.



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**8. Related Party Transactions**

Pursuant to a consulting agreement between the Company and Mr. Donald Bibeault, the Chairman of the Company's Board of Directors, Mr. Bibeault provided the Company with onsite consulting services from July 2003, when he was appointed to the Board of Directors, to September 2006. On June 29, 2006, the Company and Mr. Bibeault agreed to terminate this consulting agreement effective September 30, 2006. Under this consulting agreement, the Company incurred \$24,000 for the three months ended June 30, 2006 and \$48,000 for the six months ended June 30, 2006.

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

From time to time, information provided by us, statements made by our employees or information included in our filings with the Securities and Exchange Commission (SEC) may contain statements that are forward-looking statements involving risks and uncertainties. In particular, statements in Management's Discussion and Analysis of Financial Condition and Results of Operations relating to our revenue, profitability, growth initiatives and sufficiency of capital may be forward-looking statements. The words expect, anticipate, plan, believe, seek, estimate and expressions are intended to identify such forward-looking statements. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that could cause our future results to differ materially from those expressed in any forward-looking statements made by, or on behalf of, us. Many such factors are beyond our ability to control or predict. Readers are accordingly cautioned not to place undue reliance on forward-looking statements. We disclaim any intent or obligation to update any forward-looking statements, whether in response to new information or future events or otherwise. Important factors that may cause our actual results to differ from such forward-looking statements include, but are not limited to, the factors discussed in Item 1A of Part II of the quarterly reports for the quarterly periods ended March 31, 2007 and June 30, 2007 and of Part I of our annual report on Form 10-K for the year ended December 31, 2006 entitled Risk Factors.

**Overview**

We provide software and engineering service offerings to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) and may be connected to a network via a wired or wireless connection. Examples of smart devices that we target include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, personal digital assistants (PDAs), personal media players and smartphones. 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 have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs), silicon vendors, peripheral vendors, and enterprises that develop, market and distribute smart devices. The software and engineering services we provide our customers are utilized and deployed throughout various phases of our customers' device life cycle, including design, development, customization, quality assurance and deployment.

**Critical Accounting Judgments**

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

**Table of Contents*****Revenue Recognition***

We recognize revenue from software and engineering service sales when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the selling price is fixed or determinable; and collectability is reasonably assured. Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents, time records and customer acceptance, as and when applicable, are used to verify delivery. We assess whether the selling price is fixed or determinable based on the contract and payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history.

We recognize revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support or maintenance (PCS). As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. PCS includes rights to upgrades, when and if available, telephone support, updates, and enhancements. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. Accordingly, the judgments involved in assessing VSOE have an impact on the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition but would not change the total revenue recognized on the contract.

When elements such as software and engineering services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. In the absence of fair value for a delivered element, we allocate revenue first to the fair value of the undelivered elements and allocate the residual revenue to the delivered elements. In the absence of fair value for an undelivered element, the arrangement is accounted for as a single unit of accounting, resulting in a delay of revenue recognition for the delivered elements until the undelivered elements are fulfilled. As a result, contract interpretations and assessments of fair value are sometimes required to determine the appropriate accounting.

Service revenue from fixed-priced contracts is recognized using the percentage of completion method. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. We rely on estimates of total expected hours as a measure of performance in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period the facts that give rise to the revision become known. Service revenue from time and materials contracts and training services is recognized as services are performed.

When elements such as engineering services and royalties are contained in a single arrangement, we recognize revenue from engineering services as earned in accordance with the four revenue recognition criteria stated above even though the effective rate per hour may be lower than typical because the customer is contractually obligated to pay royalties on their devices shipments, some of which may be guaranteed. We recognize royalty revenue when we receive the royalty report from the customer of which such royalties are guaranteed and the revenue recognition criteria are met, particularly that collectability is reasonably assured.

Deferred revenue includes deposits received from customers for service contracts and unamortized service contract revenue, customer advances under OEM licensing agreements and maintenance revenue. In instances where final acceptance of the software or services is specified by the customer, revenue is deferred until all acceptance criteria have been met.

**Table of Contents*****Allowance for Doubtful Accounts***

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

***Stock-Based Compensation***

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to January 1, 2006, we accounted for stock options according to the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*, and, therefore, no related compensation expense was recorded for awards granted with no intrinsic value. We adopted the modified prospective transition method provided for under SFAS 123R and consequently have not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: 1) compensation cost related to the remaining unvested portion of all stock option awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and 2) compensation cost related to all stock option awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We record expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

At June 30, 2007, total compensation cost related to stock options granted under our stock option plans but not yet recognized was \$613,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

***Taxes***

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

**Table of Contents****Results of Operations**

The following table presents certain financial data as a percentage of total revenue. Our historical operating results are not necessarily indicative of future results:

|                                     | <b>Three Months<br/>Ended June 30,</b> |             | <b>Six Months<br/>Ended June 30,</b> |             |
|-------------------------------------|--|-------------|--------------------------------------|-------------|
|                                     | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
|                                     | <b>(unaudited)</b>                     |             | <b>(unaudited)</b>                   |             |
| Revenue:                            |  |             |                                      |             |
| Software                            | 67%                                    | 72%         | 64%                                  | 70%         |
| Service                             | 33                                     | 28          | 36                                   | 30          |
| Total revenue                       | 100                                    | 100         | 100                                  | 100         |
| Cost of revenue:                    |  |             |                                      |             |
| Software                            | 53                                     | 56          | 49                                   | 56          |
| Service                             | 24                                     | 20          | 26                                   | 22          |
| Total cost of revenue               | 77                                     | 76          | 75                                   | 78          |
| Gross profit                        | 23                                     | 24          | 25                                   | 22          |
| Operating expenses:                 |  |             |                                      |             |
| Selling, general and administrative | 18                                     | 20          | 19                                   | 21          |
| Research and development            | 4                                      | 5           | 4                                    | 6           |
| Total operating expenses            | 22                                     | 25          | 23                                   | 27          |
| Income (loss) from operations       | 1                                      | (1)         | 2                                    | (5)         |
| Interest and other income           | 3                                      |             | 2                                    | 1           |
| Income (loss) before income taxes   | 4                                      | (1)         | 4                                    | (4)         |
| Income tax expense                  | (1)                                    |             |                                      |             |
| Net income (loss)                   | 4%                                     | (1)%        | 4%                                   | (4)%        |

**Revenue**

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

Total revenue was \$15.1 million for the three months ended June 30, 2007 and \$12.6 million for the three months ended June 30, 2006, representing an increase of \$2.5 million, or 20%. Total revenue was \$30.2 million for the six months ended June 30, 2006 and \$24.2 million for the six months ended June 30, 2005, representing an increase of \$6.0 million, or 25%. These increases were due to higher sales of both software and professional engineering services as discussed below.

Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and services sold to foreign customers from our operations located in North America. We currently

have international presences in Taipei, Taiwan; Vancouver, and Tokyo, Japan. Revenue from customers located outside of North America was \$944,000 for the three months ended June 30, 2007 and \$980,000 for the three months ended June 30, 2006. Revenue from customers located outside of North America was \$1.7 million for the six months ended June 30, 2007 and \$1.5 million for the six months ended June 30, 2006.

**Table of Contents****Software revenue**

Software revenue for the three months ended June 30, 2007 and 2006 is presented below (dollars in thousands):

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |           |
|--|--------------------------------|----------|------------------------------|-----------|
|  | 2007<br>(unaudited)            | 2006     | 2007<br>(unaudited)          | 2006      |
| Software revenue:  |                                |          |                              |           |
| Third-party software   | \$ 9,148                       | \$ 8,235 | \$ 17,373                    | \$ 15,651 |
| BSQUARE proprietary software   | 1,034                          | 810      | 2,004                        | 1,249     |
| Total software revenue   | \$ 10,182                      | \$ 9,045 | \$ 19,377                    | \$ 16,900 |
| Software revenue as a percentage of total revenue                      | 67%                            | 72%      | 64%                          | 70%       |
| Third-party software revenue as a percentage of total software revenue | 90%                            | 91%      | 90%                          | 93%       |

The vast majority of our third-party software revenue is comprised of the resale of Microsoft Embedded operating systems. The majority of our proprietary software revenue in 2007 is attributable to royalty revenue from several Asia Pacific service contracts, which contain minimum guaranteed royalties, our SDIO software product and our reference designs.

Software revenue was \$10.2 million for the three months ended June 30, 2007 and \$9.0 million for the three months ended June 30, 2006, representing an increase of \$1.2 million, or 13%. Software revenue was \$19.4 million for the six months ended June 30, 2007 and \$16.9 million for the six months ended June 30, 2006, representing an increase of \$2.5 million, or 15%. These increases were due to higher sales of both third-party and proprietary software sales.

Third-party software revenue was \$9.1 million for the three months ended June 30, 2007 and \$8.2 million for the three months ended June 30, 2006, representing an increase of \$900,000, or 11%. Third-party software revenue was \$17.4 million for the six months ended June 30, 2007 and \$15.7 million for the six months ended June 30, 2006, representing an increase of \$1.7 million, or 11%. These increases in third-party software revenue were primarily due to one large sale this quarter.

We expect third-party software sales to increase approximately 5% to 10% in fiscal year 2007 as compared to fiscal year 2006 based primarily on Microsoft's market forecasts with some seasonality affecting the third quarter.

Proprietary software revenue was \$1,034,000 for the three months ended June 30, 2007 and \$810,000 for the three months ended June 30, 2006, representing an increase of \$224,000, or 28%. Proprietary software revenue was \$2.0 million for the six months ended June 30, 2007 and \$1.2 million for the six months ended June 30, 2006, representing an increase of approximately \$800,000, or 67%. These increases were due to \$403,000 of royalty revenue for the three months ended June 30, 2007 and \$758,000 of royalty revenue for the six months ended June 30, 2007 from Asia Pacific service contracts, some of which contain minimum guaranteed royalties, and higher sales of our reference design products including Schema BSP and our IDP Development kits, partially offset by lower sales of our SDIO product. Revenue from our reference design products increased due to the launch of our PXA 270 and PXA 320 development platforms. Sales of our SDIO product decreased primarily due to competing technology introduced by Microsoft. There was an immaterial amount of royalty revenue from the Asia Pacific service contracts in the three and six months ended June 30, 2006.

We expect proprietary software revenue to increase approximately 50-70% in fiscal 2007 as compared to fiscal 2006 based on renewed strength of SDIO product sales, increased reference design and related product revenue and royalty revenue resulting from the introduction of new reference designs and royalty revenue stemming from certain

Asia Pacific service contracts assuming these customers fulfill their contractual obligations.



**Table of Contents*****Service revenue***

Service revenue was \$4.9 million for the three months ended June 30, 2007 and \$3.6 million for the three months ended June 30, 2006, representing an increase of \$1.3 million, or 36%. Service revenue represented 33% of total revenue for the three months ended June 30, 2007 and 28% of total revenue for the three months ended June 30, 2006. The increase in service revenue over the same period last year was primarily due to a 31% increase in billable hours driven by strength in the North American market and a 5% increase in our realized rate per hour. The increase in North American billable hours was driven by improved market conditions, sales improvements and a 71% increase in the average size of projects stemming from a sales strategy shift toward larger, more complex projects.

Service revenue was \$10.8 million for the six months ended June 30, 2007 and \$7.3 million for the six months ended June 30, 2006, representing an increase of \$3.5 million, or 48%. Service revenue represented 36% of total revenue for the six months ended June 30, 2007 and 30% of total revenue for the six months ended June 30, 2006. The increase in service revenue over the same period last year was primarily due to a 32% increase in billable hours driven entirely by strength in the North American market, an 8% increase in our realized rate per hour and an increase in our rebillable service revenue driven primarily by one large project. The increase in North American billable hours and the was driven by the same factors noted above.

The increase in the realized rate per hour for the three and six months ended June 30, 2007 resulted primarily from a significant increase in our Asia Pac realized rate per hour driven by the completion of several, significant low-margin service projects in the prior year, partially offset by a decline in the North American rate due to \$156,000 in service revenue not recognized during the three months ended June 30, 2007 under our revenue recognition policies. Rebillable service revenue was \$1.2 million for the six months ended June 30, 2007 and \$362,000 for the six months ended June 30, 2006.

We expect service revenue to increase approximately 30% to 40% in fiscal 2007 as compared to fiscal 2006 based on improvement in the marketplace, growth in our sales capacity and account base, and increases in our realized rate per hour attributable to the fact that during fiscal 2006 we were working on several large, low-margin projects in Asia Pacific.

***Gross profit and Gross Margin***

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software and the costs of components for our hardware reference designs, product media, product duplication and manuals. Amortization of intangible assets, acquired from Vibren in June 2005, is included in cost of software revenue and was \$48,000 for the three months ended June 30, 2007 and 2006. Amortization of intangible assets is included in cost of software revenue and was \$96,000 for the six months ended June 30, 2007 and 2006. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, plus related facilities and depreciation costs. Gross profit on the sales of third-party software products are also positively affected by rebates and volume discounts we receive from Microsoft which we earn through the achievement of defined objectives. Rebates comprised \$190,000 of our gross profit for the three months ended June 30, 2007 and \$269,000 for the three months ended June 30, 2006. Rebates comprised \$348,000 of our gross profit for the six months ended June 30, 2007 and \$356,000 for the six months ended June 30, 2006. Microsoft recently modified its rebate program, although the effect was not material for the three months ended June 30, 2007, and may do so again in the future which could have the effect of reducing, or even eliminating, the rebate credit we earn that positively impacts our gross profit.

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

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
|   | <b>(unaudited)</b>        |             | <b>(unaudited)</b>      |             |
| Software gross profit                     | \$2,245                   | \$1,987     | \$4,618                 | \$3,366     |
| As a percentage of total software revenue | 22%                       | 22%         | 24%                     | 20%         |
| Service gross profit                      | \$1,262                   | \$1,020     | \$2,886                 | \$1,958     |
| As a percentage of service revenue        | 26%                       | 28%         | 27%                     | 27%         |
| Total gross profit                        | \$3,507                   | \$3,007     | \$7,504                 | \$5,324     |
| As a percentage of total revenue          | 23%                       | 24%         | 25%                     | 22%         |

**Software gross profit and gross margin**

Software gross profit as a percentage of software revenue was 22% for the three months ended June 30, 2007 and 2006. Software gross profit as a percentage of software revenue was 24% for the six months ended June 30, 2007 and 20% for the six months ended June 30, 2006. The year-to-date increase in software gross profit percentage was primarily due to the increase in high margin proprietary software sales as a percentage of total software revenue coupled with an increase in the gross margin on third-party software sales. Our proprietary software sales typically generate high gross margins (91% through June 30, 2007), while third-party software sales typically generate much lower gross margins. Third-party software gross profit as a percentage of third-party software revenue was 14% for the three months ended June 30, 2007 and 15% for the three months ended June 30, 2006. Third-party software gross profit as a percentage of third-party software revenue was 16% for the six months ended June 30, 2007 and 15% for the six months ended June 30, 2006.

We expect third-party software sales to continue to be a significant percentage of our software revenue, and, therefore, our software gross margin will likely remain relatively low in the foreseeable future. Further, our third-party software gross margin may decline in the future based primarily on increased competitive pressures. We expect our proprietary software gross margin to improve in 2007 based on higher revenue levels and the discontinuance in the third quarter of 2007 of the Vibren intangible asset amortization discussed previously.

**Service gross profit and gross margin**

Service gross profit was \$1.3 million for the three months ended June 30, 2007 and \$1.0 million for the three months ended June 30, 2006, representing an increase of approximately \$300,000, or 30%. Service gross profit was \$2.9 million for the six months ended June 30, 2007 and \$2.0 million for the six months ended June 30, 2006, representing an increase of approximately \$900,000, or 45%. Service gross profit as a percentage of service revenue was 26% for the three months ended June 30, 2007 and 28% for the three months ended June 30, 2006. Service gross profit as a percentage of service revenue was 27% for the six months ended June 30, 2007 and 2006. The overall improvement in service gross profit is attributable to increased service revenue and a 13% increase in our realized rate per hour year-over-year. Additionally, our facilities and depreciation costs, a portion of which is included in service cost of revenue, are relatively fixed and are being spread over a larger revenue base which has the effect of increasing service gross profit as service revenue increases. Facilities and related allocations and other fixed costs were 10% of total service cost of revenue for the three months ended June 30, 2007 and 14% for the three months ended June 30, 2006.

We expect service gross profit and service gross margin to improve throughout the year as a result of anticipated increases in service revenue above certain fixed costs such as facilities, the previous completion of several low-margin Asia Pacific contracts, which had the affect of suppressing service margin and a anticipated decline in certain service expenses, particularly fringe benefit expense.

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***Operating expenses***

***Selling, general and administrative***

Selling, general and administrative expenses consist primarily of salaries and benefits for our sales, marketing and administrative personnel and related facilities and depreciation costs as well as professional services fees (e.g., consulting, legal and audit).

Selling, general and administrative expenses were \$2.7 million for the three months ended June 30, 2007 and \$2.5 million for the three months ended June 30, 2006, representing an increase of approximately \$200,000, or 8%. Selling, general and administrative expenses represented 18% of total revenue for the three months ended June 30, 2007 and 20% for the three months ended June 30, 2006.

Selling, general and administrative expenses were \$5.6 million for the six months ended June 30, 2007 and \$5.0 million for the six months ended June 30, 2006, representing an increase of approximately \$600,000, or 12%. Selling, general and administrative expenses represented 19% of total revenue for the six months ended June 30, 2007 and 21% for the six months ended June 30, 2006.

These increases were primarily due to higher personnel costs and professional fees. Personnel costs increased due to higher incentive compensation costs driven by higher sales. Professional fees increased due to higher consulting fees for Sarbanes-Oxley compliance. We expect selling, general and administrative costs to remain relatively flat throughout the remainder of 2007.

***Research and development***

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

Research and development expenses were \$598,000 for the three months ended June 30, 2007 and \$672,000 for the three months ended June 30, 2006, representing a decrease of \$74,000, or 11%. Research and development expenses represented 4% of total revenue for the three months ended June 30, 2007 and 5% for the three months ended June 30, 2006.

Research and development expenses were \$1.1 million for the six months ended June 30, 2007 and \$1.4 million for the six months ended June 30, 2006, representing a decrease of approximately \$300,000, or 21%. Research and development expenses represented 4% of total revenue for the three months ended June 30, 2007 and 6% for the three months ended June 30, 2006.

These decreases were primarily due to lower salaries and contractor costs and related expenses resulting from lower headcount, as well as decreased headcount-based facilities expenses. We are continuing to execute and evolve our product strategy and expect to continue to invest in new product development initiatives as appropriate throughout the remainder of 2007. We currently expect our research and development expenses to increase moderately throughout 2007 as we make certain selected investments in reference designs and other products but expect total fiscal 2007 research and development expense to be comparable to fiscal 2006 levels.

**Table of Contents*****Interest and other income***

Interest and other income primarily consists of interest earnings on our cash, cash equivalents and short-term investments. Interest and other income was \$444,000 for the three months ended June 30, 2007 and \$115,000 for the three months ended June 30, 2006, representing an increase of \$329,000, or 286%. Interest and other income was \$567,000 for the six months ended June 30, 2007 and \$202,000 for the six months ended June 30, 2006, representing an increase of \$365,000, or 181%. These increases were due to a realized gain on the sale of marketable securities of \$287,000, which occurred during this quarter, higher income producing balances and higher prevailing interest rates in the current year as compared to the prior year.

***Income Tax Expense***

Income tax expense was \$108,000 for the three months ended June 30, 2007 and \$26,000 for the three months ended June 30, 2006. Income tax expense was \$148,000 for the six months ended June 30, 2007 and \$26,000 for the six months ended June 30, 2006. This expense relates to corporate income taxes generated by our Taiwan subsidiary. We expect our Taiwan subsidiary to become increasingly profitable and, therefore, expect income tax expense to continue for the foreseeable future.

***Liquidity and Capital Resources***

As of June 30, 2007, we had \$12.4 million of cash, cash equivalents and short-term investments, which included restricted cash of \$1,050,000, compared to \$11.1 million at December 31, 2006, which included restricted cash of \$1.2 million. This restricted cash secures our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital at June 30, 2007 was \$12.5 million compared to \$10.3 million at December 31, 2006. The increase in working capital was primarily due to an increase in our short-term investments and accounts receivable balances at June 30, 2007 as compared to December 31, 2006.

During the six months ended June 30, 2007, operating activities provided cash of \$1.1 million attributable to our net income of \$1.2 million and non-cash expenses of \$725,000, offset by certain working capital items. During the six months ended June 30, 2006, net cash provided by operating activities was \$367,000. This cash provided was primarily attributable to a \$516,000 decrease in accounts receivable driven by improved cash collections, offset by our net loss of \$937,000 excluding the effect of non-cash expenses totaling \$584,000.

During the six months ended June 30, 2007, investing activities utilized approximately \$3.3 million of cash attributable to \$3.1 million invested in short-term investments and \$267,000 used to purchase capital equipment, partially offset by \$150,000 received through a reduction in our line of credit. Investing activities for the six months ended June 30, 2006 included \$4.2 million used in purchases of short-term investments and \$169,000 used to purchase capital equipment. We expect to invest approximately \$132,000 in capital expenditures throughout the remainder of the year.

Financing activities generated \$685,000 in cash during the six months ended June 30, 2007 and \$69,000 during the six months ended June 30, 2006 as a result of exercises of stock options. The amount of stock option proceeds increased considerably during the six months ended June 30, 2007 as compared to the prior year due to an increase in our stock price and resulting impact on the number of exercises.

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

**Table of Contents****Tabular Disclosure of Contractual Obligations**

We have significant lease commitments, which expire at various times through 2014. We have operating lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Vancouver, British Columbia, Canada; and Taipei, Taiwan. The following are our contractual commitments associated with these lease and other obligations (in thousands):

| Contractual Obligations         | Payments Due through Year Ended December 31, |        |        |        |        |            | Total    |
|---------------------------------|--|--------|--------|--------|--------|------------|----------|
|                                 | 2007   | 2008   | 2009   | 2010   | 2011   | Thereafter |          |
| Long-term debt obligations      | \$   | \$     | \$     | \$     | \$     | \$         | \$       |
| Equipment financing obligations |  |        |        |        |        |            |          |
| Operating lease obligations     | 513  | 953    | 853    | 926    | 975    | 2,889      | 7,109    |
| Purchase obligations            |  |        |        |        |        |            |          |
| Other long-term obligations     |  |        |        |        |        |            |          |
| Total                           | \$ 513                                       | \$ 953 | \$ 853 | \$ 926 | \$ 975 | \$ 2,889   | \$ 7,109 |

In addition to these lease obligations, we are potentially obligated under our headquarters lease. Specifically, in February 2004, we signed an amendment to the lease for our former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters. If we default under our new corporate headquarters lease, the landlord has the ability to demand repayment for certain cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was \$1.7 million at June 30, 2007, which decreases on the straight-line basis over the length of the headquarters lease.

**Related Party Transactions**

Pursuant to a consulting agreement between us and Mr. Donald Bibeault, the Chairman of our Board of Directors, Mr. Bibeault provided us with onsite consulting services from July 2003, when he was appointed to our Board of Directors, to September 2006. On June 29, 2006, we and Mr. Bibeault agreed to terminate this consulting agreement effective September 30, 2006. Under this consulting agreement, we incurred \$24,000 for the three months ended June 30, 2006 and \$48,000 for the six months ended June 30, 2006.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Interest Rate Risk.* We do not hold derivative financial instruments or equity securities in our short-term investment portfolio. Our cash equivalents consist of high-quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one issue to a maximum of 15% and any one issuer to a maximum of 10% of the total portfolio with the exception of treasury securities, commercial paper and money market funds, which are exempt from size limitation. The policy limits all short-term investments to those with maturities of two years or less, with the average maturity being one year or less. These securities are subject to interest rate risk and will decrease in value if interest rates increase.

*Foreign Currency Exchange Rate Risk.* Currently, the majority of our revenue and expenses is denominated in U.S. dollars, and, as a result, we have not experienced significant foreign exchange gains and losses to date. While we have conducted some transactions in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant. We have not engaged in foreign currency hedging to date, although we may do so in the future.

Our exposure to foreign exchange rate fluctuations can vary as the financial results of our foreign subsidiaries are translated into U.S. dollars in consolidation. The effect of foreign exchange rate fluctuations for the three and six months ended June 30, 2007 and June 30, 2006 was not material.

**Item 4. Controls and Procedures**

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

There has been no change in our internal control over financial reporting during the six months ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

**IPO Litigation**

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

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

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On July 15, 2002, we moved to dismiss all claims against us and the Individual Defendants. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the district court denied the motion to dismiss the complaint against us. On October 13, 2004, the district court certified a class in six of the approximately 300 other nearly identical actions (the focus cases ) and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants appealed this decision and the Second Circuit vacated the district court s decision granting class certification in the six focus cases on December 5, 2006. Plaintiffs filed a petition for rehearing. On January 5, 2007, the Second Circuit denied the petition, but noted that the plaintiffs could ask the district court to certify a more narrow class than the one that was rejected. The plaintiffs have not yet moved to certify a class in our case.

Prior to the Second Circuit s ruling, the majority of the issuers, including us, and the insurers had submitted a settlement agreement to the district court for approval. In light of the Second Circuit opinion, the parties agreed that the settlement could no longer be approved because the settlement class, like the litigation class, cannot be certified. On June 25, 2007, the district court approved a stipulation filed by the plaintiffs and the issuers which terminated the proposed settlement. The plaintiffs now plan to replead their complaints and move for class certification again. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit s mandate, nor can we predict the amount of any such settlement and whether that amount would be greater than the Company s insurance coverage. If we are found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.

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**Item 1A. Risk Factors**

The following risk factors and other information in this quarterly report on Form 10-Q and also those discussed in our annual report on Form 10-K for the year-ended December 31, 2006 and in our quarterly report on Form 10-Q for the three months ended March 31, 2007 should be carefully considered. The risks and uncertainties described below and discussed in our most recent reports referenced above are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. If any of the these risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected. Beginning with the quarterly report on Form 10-Q for the three months-ended March 31, 2007, we no longer repeat risk factors that were disclosed in our most recent annual report on Form 10-K which have not changed substantially, including financial/numerical information where such information has not changed materially or where the relationship of such information to other financial information has not changed materially. Instead, we will update risk factors disclosed in our most recent annual report on Form 10-K and in our quarterly reports on Form 10-Q as necessary where changes or updates are deemed significant and will add new risk factors not previously disclosed as they become pertinent to our business. To the extent a risk factor is no longer considered relevant that was described in our most recent annual report on Form 10-K, it will be deleted in the annual report on Form 10-K filed for the year-ending December 31, 2007.

**Microsoft-Related Risk Factors**

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

We have an OEM Distribution Agreement (ODA) with Microsoft, which enables us to resell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico. Software sales under this agreement constitute a significant portion of our revenue. If the ODA was terminated, our software revenue and resulting gross profit would decrease significantly and our operating results would be negatively impacted. The ODA is renewable annually, and there is no automatic renewal provision in the agreement. We disclosed in our most recent annual report on Form 10-K that the ODA was last renewed in October 2006 and would expire on June 30, 2007. The ODA was renewed in June, 2007 and will now expire on June 30, 2008, unless terminated earlier under the provisions of the ODA. There were no material changes to the provisions of the ODA as a result of the renewal.

**Microsoft has audited our records under our OEM Distribution Agreement in the past and will do so again in the future, and any negative audit results could result in additional charges and/or the termination of the ODA.**

We disclosed in our most recent annual report on Form 10-K that Microsoft had notified us during the fourth quarter of 2006 that it would be conducting an audit of our records pertaining to the ODA. A similar audit conducted in 2003 and 2004 resulted in a payment to Microsoft of \$310,000. We completed the current audit, which covered the period from December of 2003 through September 2006, during this quarter. There were no material findings.



**Table of Contents****Item 4. Submission of Matters to a Vote of Security Holders**

On June 6, 2007, the following matters were submitted to a vote at the Annual Meeting of Shareholders:

**Proposal 1:** Election of Directors. Three Class I directors were elected at our 2007 Annual Meeting for three-year terms ending in 2010 by the vote set forth below:

| <b>Nominee</b>            | <b>Shares<br/>For</b> | <b>Shares<br/>Withheld</b> |
|---------------------------|-----------------------|----------------------------|
| Elliott H. Jurgensen, Jr. | 8,500,855             | 623,515                    |
| Scot E. Land              | 8,500,343             | 624,027                    |
| Kendra A. VanderMeulen    | 8,499,143             | 625,227                    |

**Proposal 2:** The proposal to modify the Company's existing Board of Directors compensation program was approved by the vote set forth below:

|           | <b>Voted</b> |
|-----------|--------------|
| For       | 3,901,601    |
| Against   | 1,103,005    |
| Abstain   | 123,749      |
| Not voted | 4,622,276    |

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**Item 6. Exhibits**

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

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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: August 9, 2007

By:           /s/ Brian T. Crowley  
                  Brian T. Crowley  
                  *President and Chief Executive Officer*

Date: August 9, 2007

By:           /s/ Scott C. Mahan  
                  Scott C. Mahan  
                  *Vice President, Finance and Chief  
                  Financial Officer*

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**BSQUARE CORPORATION  
INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number<br/>(Referenced to<br/>Item 601 of<br/>Regulation<br/>S-K)</b> | <b>Exhibit<br/>Description</b>  |
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