BSQUARE CORP /WA
Form 10-Q
May 09, 2008

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

FORM 10-Q

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

For the quarterly period ended March 31, 2008

OR

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

For the transition period from __________ to __________

Commission File Number: 000-27687

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

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

(425) 519-5900
(Registrant s telephone number, including area code)

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

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

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

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

The number of shares of common stock outstanding as of April 30, 2008: 9,997,193

BSQUARE CORPORATION
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

BSQUARE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	March 31, 2008 (Unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,695	$ 4,377
Short-term investments	325	9,575
Accounts receivable, net of allowance for doubtful accounts of $198 at March 31, 2008 and $199 at December 31, 2007	9,837	8,273
Prepaid expenses and other current assets	744	377
Total current assets	17,601	22,602
Equipment, furniture and leasehold improvements, net	810	824
Intangible assets, net	208	230
Restricted cash	1,050	1,050
Long-term investments	7,950	
Other non-current assets	59	56
Total assets	$ 27,678	$ 24,762
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,332	$ 2,619
Other accrued expenses	3,379	2,877
Accrued compensation	1,678	1,393
Accrued legal fees	534	534
Deferred revenue	415	493
Total current liabilities	9,338	7,916
Deferred rent	325	331
Commitments and contingencies (Note 6)		
Shareholders equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 9,992,193 shares issued and outstanding at March 31, 2008 and 9,967,618 shares issued and outstanding at December 31, 2007	121,535	121,118
Accumulated other comprehensive loss	(366)	(409)

Accumulated deficit	(103,154)	(104,194)
Total shareholders equity	18,015	16,515
Total liabilities and shareholders equity	$ 27,678	$ 24,762

See notes to condensed consolidated financial statements.

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

	Three Months Ended March 31, 2008	2007
	(unaudited)	
Revenue:		
Software	$ 10,996	$ 9,195
Service	6,062	5,901
Total revenue	17,058	15,096
Cost of revenue:		
Software	8,397	6,822
Service [(1)]	4,011	4,277
Total cost of revenue	12,408	11,099
Gross profit	4,650	3,997
Operating expenses:		
Selling, general and administrative [(1)]	3,009	2,897
Research and development [(1)]	644	545
Total operating expenses	3,653	3,442
Income from operations	997	555
Interest and other income	160	123
Income before income taxes	1,157	678
Income tax expense	(117)	(40)
Net income	$ 1,040	$ 638
Basic income per share	$ 0.10	$ 0.07
Diluted income per share	$ 0.10	$ 0.06
Shares used in calculation of income per share:		
Basic	9,977	9,677
Diluted	10,149	9,953

(1) Includes the following

amounts related to non-cash stock-based compensation expense:		
Cost of revenue service	$ 125	$ 48
Selling, general and administrative	240	120
Research and development	19	21
Total stock-compensation expense	$ 384	$ 189

See notes to condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2008	2007
	(unaudited)	
Cash flows from operating activities:		
Net income	$ 1,040	$ 638
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	137	147
Stock-based compensation	384	189
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,558)	(832)
Prepaid expenses and other assets	(369)	(44)
Accounts payable and accrued expenses	1,500	286
Deferred revenue	(79)	213
Deferred rent	(6)	(6)
Net cash provided by operating activities	1,049	591
Cash flows from investing activities:		
Purchases of equipment and furniture	(101)	(96)
Proceeds from reduction of restricted cash		150
Purchases of investments		1,000
Maturities of investments	1,300	(2,100)
Net cash provided by (used in) investing activities	1,199	(1,046)
Cash flows from financing activities:		
Proceeds from exercise of stock options	33	348
Net cash provided by financing activities	33	348
Effect of exchange rate changes on cash	37	(8)
Net increase (decrease) in cash and cash equivalents	2,318	(115)
Cash and cash equivalents, beginning of period	4,377	2,483
Cash and cash equivalents, end of period	$ 6,695	$ 2,368

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2008
(unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

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

Earnings Per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as options and warrants. Diluted earnings per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock or if-converted method in the case of stock options and warrants, respectively. Common stock equivalent shares are excluded from the computation if their effect is antidilutive. Common stock equivalent shares were 2,205,272 at March 31, 2008 and 2,063,105 at March 31, 2007.

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

	Three Months Ended March 31,	
	2008	**2007**
Weighted average shares outstanding for basic earnings per share	9,977	9,677
Dilutive effect of common stock equivalent shares	172	276
Weighted average shares outstanding for diluted earnings per share	10,149	9,953

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2. Investments

The Company s investments consist of auction rate securities, or ARS. ARS are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long term, they are generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed.) The Company has investments in ARS valued at $7,975,000 as of March 31, 2008 which have failed at auction. These investments are illiquid and the Company is unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is subject to either a successful auction process, redemption of the investment, or a sale of the security in a secondary market. The failed ARS carry AAA ratings and continue to pay interest according to the stated terms. There has been no reduction in fair value of the underlying collateral of the Company s ARS portfolio. As of March 31, 2008, the Company has reclassified the balance of failed ARS on its balance sheet from short-term investments to long-term investments due to the uncertainty in timing of liquidating these investments.

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

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

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

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

Fair value measurements of the Company s ARS as of March 31, 2008 were as follows:

	Fair Value Measurements as of March 31, 2008 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(in thousands)			
Auction rate securities:				
Student loan backed	$	$ 4,050	$	$ 4,050
Closed-end funds	25	3,400		3,425
Municipal	300			300
Corporate collateral		500		500

Total auction rate securities	$	325	$	7,950	$		$ 8,275
Amounts included in:							
Short-term investments	$	325	$		$		$ 325
Long-term investments				7,950			7,950
Total	$	325	$	7,950	$		$ 8,275

As of March 31, 2008, the total fair value of the Company s ARS was $8.3 million, which was measured using Level 1 inputs for the non-failed securities and Level 2 inputs for the failed securities. However, since February 2008, there have been insufficient buyers for these ARS; therefore the Company transferred the failed ARS, or $7,950,000, from the Level 1 to the Level 2 category as of March 31, 2008.

Subsequent to March 31, 2008, $325,000 of the ARS have been redeemed and the Company has received notice that an additional $1.7 million is scheduled to be redeemed in May 2008.

3. Intangible Assets

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

	March 31, 2008	December 31, 2007
Gross carrying value of the acquired intangible assets subject to amortization	$ 230	$ 230
Accumulated amortization	22	
Net book value	$ 208	$ 230

Amortization expense was $22,000 for the three months ended March 31, 2008 and $50,000 for the three months ended March 31, 2007. Amortization expense is expected to be $67,000 for the remainder of 2008.

4. Stock-Based Compensation

Stock Options

In May 1997, the Company adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at 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 allows for awards of stock appreciation rights, restricted and unrestricted stock and restricted stock units.

The Company also has a Non-Qualified Stock Option Plan, under which, the Board of Directors may grant non-qualified stock options at 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 over four years.

Restricted Stock Awards

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

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Stock-Based Compensation

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

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

	Three Months Ended March 31,	
	2008	2007
Cost of revenue service	$ 125	$ 48
Selling, general and administrative	240	120
Research and development	19	21
Total stock-based compensation expense	$ 384	$ 189

Stock-based compensation expense under SFAS123R reduced net income by $384,000 and diluted earnings per share by $0.04 for the three months ended March 31, 2008. Stock-based compensation expense under SFAS123R reduced net income by $189,000 and diluted earnings per share by $0.02 for the three months ended March 31, 2007.

At March 31, 2008, total compensation cost related to stock options granted under the Company s stock option plans but not yet recognized was $656,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

At March 31, 2008, total compensation cost related to restricted stock awards granted under the Company s stock plans but not yet recognized was $90,000. This cost will be amortized on the straight-line method over a period of approximately eight months.

At March 31, 2008, total compensation cost related to restricted stock units granted under the Company s stock plans but not yet recognized was $341,000. This cost will be amortized on the straight-line method over a period of approximately 1.8 years.

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Key Assumptions

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

	Three Months Ended March 31,	
	2008	2007
Dividend yield	0%	0%
Expected life	4 years	4 years
Expected volatility	81%	86%
Risk-free interest rate	2.4%	4.7%
Estimated forfeitures	22%	35%

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

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

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

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

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

Stock Option Activity

The following table summarizes stock option activity under the Company s stock plans for the three months ended March 31, 2008:

Stock Options	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)		Aggregate Intrinsic Value
Outstanding at January 1, 2008	1,886,717	$	4.36			
Granted at fair value	135,900		4.04			
Exercised	(8,799)		2.59			
Forfeited	(8,391)		3.83			
Expired	(9,335)		18.58			
Outstanding at March 31, 2008	1,996,092	$	4.28	7.20	$	1,586,000
Vested and expected to vest at March 31, 2008	1,661,880	$	4.44	6.95	$	1,326,000
Exercisable at March 31, 2008	1,246,117	$	4.72	6.43	$	1,028,000

The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of the Company s common stock for the number of options that were in-the-money at March 31, 2008. The Company issues new shares of common stock upon exercise of stock options.

	2008	2007
Weighted-average grant-date fair value for the three months ended March 31, 2008	$ 2.81	$ 3.19
Options in-the-money at March 31	744,638	699,631
Aggregate intrinsic value of options exercised for the three months ended March 31, 2008	$ 23,000	$ 362,000

Restricted Stock Activity

The following table summarizes restricted stock award activity under the Company s stock plans for the three months ended March 31, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value

Outstanding at January 1, 2008	21,000	$	6.32
Awarded	10,500	$	5.13
Released			
Forfeited			
Outstanding at March 31, 2008	31,500	$	5.93

The following table summarizes restricted stock unit activity under the Company s stock plans for the three months ended March 31, 2008:

	Number of Shares	Weighted Average Remaining Contractual Life (in years)		Aggregate Intrinsic Value
Outstanding at January 1, 2008	94,728			
Awarded	22,817			
Released	(5,765)			
Forfeited	(2,600)			
Outstanding at March 31, 2008	109,180	2.09	$	426,000
Vested and expected to vest at March 31, 2008	67,247	1.57	$	262,000

The weighted-average grant-date fair value of restricted stock units granted for the three months ended March 31, 2008 was $5.79**.**

5. Comprehensive Income (Loss)

Comprehensive income (loss) consists of two components, net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders equity under generally accepted accounting principles but are excluded from net income (loss). The Company s other comprehensive income (loss) is comprised of foreign currency translation adjustments from its subsidiaries not using the U.S. dollar as their functional currency. The components of other comprehensive income (loss) consisted of foreign currency translation gain of $43,000 for the three months ended March 31, 2008 and a foreign currency translation loss of $12,000 for the three months ended March 31, 2007.

6. Commitments and Contingencies

Contractual Commitments

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

In February 2004, the Company amended the lease of its former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters, also located in Bellevue, Washington. If the Company defaults under its corporate headquarters lease, the landlord has the ability to demand repayment for certain cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was $1.5 million at March 31, 2008, which decreases on the straight-line basis over the length of its ten-year headquarters lease.

Rent expense was $279,000 for the three months ended March 31, 2008 and $272,000 for the three months ended March 31, 2007.

As of March 31, 2008, 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 March 31, 2008 were as follows (in thousands):

Operating leases:	
Remainder of 2008	$ 928
2009	1,137
2010	1,118
2011	1,039
2012	1,030
Thereafter	1,859
Total commitments	$ 7,111

Legal Proceedings

IPO Litigation

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

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

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

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

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7. Segment Information

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

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

	Three Months Ended March 31,	
	2008	**2007**
Total revenue:		
North America	$ 15,385	$ 14,315
Asia	1,434	769
Other foreign	239	12
Total revenue (1)	$ 17,058	$ 15,096

	March 31, 2008	December 31, 2007
Long-lived assets:		
North America	$ 973	$ 1,017
Asia	45	37
Total long-lived assets	$ 1,018	$ 1,054

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

Significant Customers

No customers accounted for 10% or more of total revenue for the three months ended March 31, 2008. One customer had an accounts receivable balance of approximately $1.4 million, or 14% of total accounts receivable as of March 31, 2008. As of April 30, 2008, the Company had collected $495,000 of the March 31, 2008 balance from this customer. There were no other customers that accounted for 10% or more of total accounts receivable as of March 31, 2008.

For the three months ended March 31, 2007, the Company had one customer that accounted for $1.8 million, or 12% of total revenue. Sales to this customer, which was predominantly engineering services, included $845,000 of rebillable service revenue which does not have a material impact on the Company s gross profit. Excluding rebillable services, this customer only accounted for 6% of revenue. There were no other customers that accounted for 10% or more of total revenue for the three months ended March 31, 2007. In addition, this customer had an accounts receivable balance of approximately $1.5 million, or 19% of total accounts receivables as of March 31, 2007. There were no other customers that accounted for 10% or more of total accounts receivable as of March 31, 2007.

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

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

Overview

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

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

Critical Accounting Judgments

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

Revenue Recognition

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

We recognize software revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. Service revenue from time and materials contracts and training services is recognized as services are performed. For certain fixed-price professional engineering service contracts that require significant production, modification, or customization of software, we account for these arrangements using the percentage-of-completion method under Statement Of Position (SOP) 81-1, as contemplated by paragraph 7 of SOP 97-2. We use the percentage-of-completion method of accounting specified within SOP 81-1, as contrasted to alternative approaches outlined in SOP 81-1, because it is the most preferable method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; it is a better measure of periodic income results than other methods in our case and it better matches revenue recognized with the costs incurred in our instance. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. We rely on estimates of total expected hours as a measure of performance in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period the facts that give rise to the revision become known.

We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support or maintenance (PCS). As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. PCS includes rights to upgrades, when and if available, telephone support, updates, and enhancements. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. Accordingly, the judgments involved in assessing VSOE have an impact on the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition but would not change the total revenue recognized on the contract.

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

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

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

Allowance for Doubtful Accounts

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

Stock-Based Compensation

We record 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. 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 March 31, 2008, total compensation cost related to stock options granted under our stock option plans but not yet recognized was $656,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

At March 31, 2008, total compensation cost related to restricted stock awards granted under our stock plans but not yet recognized was $90,000. This cost will be amortized on the straight-line method over a period of approximately 8 months.

At March 31, 2008, total compensation cost related to restricted stock units granted under our stock plans but not yet recognized was $341,000. This cost will be amortized on the straight-line method over a period of approximately 1.8 years.

Taxes

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

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

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Results of Operations

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

	As a Percentage of Total Revenue Three Months Ended March 31,	
	2008	2007
	(unaudited)	
Revenue:		
Software	64%	61%
Service	36	39
Total revenue	100	100
Cost of revenue:		
Software	49	45
Service	24	28
Total cost of revenue	73	73
Gross profit	27	27
Operating expenses:		
Selling, general and administrative	17	19
Research and development	4	4
Total operating expenses	21	23
Income from operations	6	4
Interest and other income	1	
Income before income taxes	7	4
Income tax expense	(1)	
Net income	6%	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 activities, support contracts, fees for customer training, and rebillable expenses.

Total revenue was $17.1 million for the three months ended March 31, 2008 and $15.1 million for the three months ended March 31, 2007, representing an increase of $2.0 million, or 13%. This increase was 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 engineering services billed to foreign customers from our operations located in North

America. We currently have operations outside North America in Taipei, Taiwan and Tokyo, Japan. Revenue from customers located outside of North America was $1.7 million for the three months ended March 31, 2008 and $781,000 for the three months ended March 31, 2007, representing an increase of $919,000, or 118%. This increase was primarily due to royalty revenue related to Asia Pacific engineering service contracts.

We had no customers that accounted for 10% or more of total revenue for the three months ended March 31, 2008. For the three months ended March 31, 2007, we had one customer that accounted for $1.8 million, or 12% of total revenue. Sales to this customer, which was predominantly engineering services, included $845,000 of rebillable service revenue on which we earn a small gross profit. Excluding rebillable services, this customer only accounted for 6% of revenue. There were no other customers that accounted for 10% or more of total revenue for the

three months ended March 31, 2007.

Software revenue

Software revenue for the three months ended March 31, 2008 and 2007 is presented below (dollars in thousands):

	Three Months Ended March 31,	
	2008	**2007**
	(unaudited)	
Software revenue:		
Third-party software	$ 10,133	$ 8,225
BSQUARE proprietary software	863	970
Total software revenue	$ 10,996	$ 9,195
Software revenue as a percentage of total revenue	64%	61%
Third-party software revenue as a percentage of total software revenue	92%	89%

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

Third-party software revenue was $10.1 million for the three months ended March 31, 2008 and $8.2 million for the three months ended March 31, 2007, representing an increase of $1.9 million, or 23%. The increase in third-party software revenue was due to an increase in higher sales to several of our larger customers and revenue from Flash Lite licensing which began in December 2007. We generated $450,000 in Flash Lite licensing revenue for the three months ended March 31, 2008 compared to none for the three months ended March 31, 2007. We currently expect third-party software revenue to increase approximately 15% to 20% in fiscal year 2008, as compared to fiscal 2007, based on overall growth in the general embedded market, and in Microsoft s share of that market, as well increased revenue contribution from additional third-party software product offerings such as Adobe Flash Lite and Solidcore s S3 Control product.

Proprietary software revenue was $863,000 for the three months ended March 31, 2008 and $970,000 for the three months ended March 31, 2007, representing a decrease of $107,000, or 11%. This decrease was due to lower SDIO and reference design revenue. We currently expect proprietary software revenue to decrease slightly in fiscal 2008, as compared to fiscal 2007, primarily due to lower royalty revenue from Asia Pacific service contracts as the guaranteed royalty periods expire, partially offset by increased reference design and related product revenue.

Service revenue

Service revenue was $6.1 million for the three months ended March 31, 2008 and $5.9 million for the three months ended March 31, 2007, representing an increase of $200,000, or 3%. Service revenue represented 36% of total revenue for the three months ended March 31, 2008 and 39% of total revenue for the three months ended March 31, 2007. A 490% increase in core engineering services revenue in the Asia Pacific region drove the increase, partially offset by a decrease in low-margin rebillable revenue of $587,000. Billable hours increased by 6% for the three months ended March 31, 2008, driven by higher activity levels in the Asia Pacific region, whereas the realized rate per hour increased by 8% for the three months ended March 31, 2008, driven by bill rate improvement in the Asia Pacific region, resulting from several low bill rate royalty-bearing service contracts we had been engaged in during the same period in 2007. We currently expect service revenue to increase approximately 15% to 20% in fiscal 2008, as compared to fiscal 2007, based on our expectation that the summer slowdown that has affected us for the last two years will do so to a lesser extent in 2008, as well as growth in our sales capacity and increased revenue from the Asia Pacific region resulting from our expansion there.

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Gross profit and gross margin

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software products, the costs of components for our hardware reference designs, product media, product duplication and manuals. Amortization of intangible assets, acquired from Vibren Technologies Inc. in June 2005 and from NECAM in December 2007, is included in cost of software revenue and was $22,000 for the three months ended March 31, 2008 and $48,000 for the three months ended March 31, 2007. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, related facilities and depreciation costs. Gross profit on the sales of third-party software products are also positively affected by rebates and volume discounts we receive from Microsoft which we earn through the achievement of defined objectives. Rebates comprised $61,000 of our gross profit for the three months ended March 31, 2008 and $158,000 of our gross profit for the three months ended March 31, 2007. Microsoft has frequently modified its rebate program, and future modifications could have the effect of reducing, or even eliminating, the rebate credit we earn.

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

	Three Months Ended March 31,	
	2008	**2007**
	(unaudited)	
Software gross profit	$2,599	$2,373
As a percentage of total software revenue	24%	26%
Service gross profit	$2,051	$1,624
As a percentage of service revenue	34%	28%
Total gross profit	$4,650	$3,997
As a percentage of total revenue	27%	26%

Software gross profit and gross margin

Software gross profit was $2.6 million for the three months ended March 31, 2008 and $2.4 million for the three months ended March 31, 2007, representing an increase of $200,000, or 8%. This increase was due to higher gross profit contribution from increased sales of third-party software sales, partially offset by a reduction in third-party software gross margin. Software gross profit as a percentage of software revenue was 24% for the three months ended March 31, 2008 and 26% for the three months ended March 31, 2007. The decrease in software gross profit percentage was primarily due to the decrease in high margin proprietary software sales as a percentage of total software revenue. Our proprietary software sales have traditionally generated high gross margins (99% this quarter), while third-party software sales typically generate much lower gross margins. Third-party software margin was 17% for the three months ended March 31, 2008, compared to 18% for the same period in the prior year with the decrease driven by higher revenue contribution from our larger, lower margin customers.

We expect third-party software sales to continue to be a significant percentage of our software revenue, and, therefore our software gross margin will likely remain relatively low in the foreseeable future. We currently expect our proprietary software gross margin to remain at relatively high levels. We currently expect our third-party software margin to increase to approximately 18% in fiscal 2008, compared to 17% in fiscal 2007, with the increase driven by gross profit contribution from higher margin third-party software products such as Flash Lite and S3 Control.

Service gross profit and gross margin

Service gross profit was $2.1 million for the three months ended March 31, 2008 and $1.6 million for the three months ended March 31, 2007, representing an increase of $500,000, or 31%. Service gross profit as a percentage of service revenue was 34% for the three months ended March 31, 2008 and 28% for the three months ended March 31, 2007. The increase in service gross profit was driven by higher revenue and improvement in service gross

margin. The improvement in service gross margin was driven primarily by an 8% increase in our realized rate per hour and a decline in low-margin rebillable service revenue.

We currently expect service gross profit to improve approximately 25% in fiscal 2008, as compared to fiscal 2007, which would result in a full-year service margin of approximately 35% in fiscal 2008, compared to 29% in fiscal 2007. The service gross margin improvement will be driven by higher revenue and activity levels which should, in turn, have a positive effect on our staff utilization.

Operating expenses

Selling, general and administrative

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

Selling, general and administrative expenses were $3.0 million for the three months ended March 31, 2008 and $2.9 million for the three months ended March 31, 2007, representing an increase of approximately $100,000, or 3%. This increase was primarily due to higher selling, general and administrative expenses in both Taiwan and Japan related to the expansion in the Asia Pacific region. Selling, general and administrative expenses represented 17% of total revenue for the three months ended March 31, 2008 and 19% of total revenue for the three months ended March 31, 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 $644,000 for the three months ended March 31, 2008 and $545,000 for the three months ended March 31, 2007, representing an increase of $99,000, or 18%. This increase was primarily due to higher salaries, contractor and development costs, driven by additional personnel costs associated with the Flash Lite technology acquisition, which occurred in December 2007, and higher reference design development costs. We continue to execute and evolve our product strategy and invest in new product development initiatives; however the timing and magnitude of our investments are difficult to predict. Research and development expenses represented 4% of total revenue for the three months ended March 31, 2008 and 2007.

Interest and other income

Interest and other income consists of interest earnings on our cash, cash equivalents and short-term investments. Interest and other income was $160,000 for the three months ended March 31, 2008 and $123,000 for the three months ended March 31, 2007, representing an increase of $37,000, or 30%. This increase was due to higher income producing balances in the current year, partially offset by lower interest rates as compared to the prior year.

Income Tax Expense

Income tax expense was $117,000 for the three months ended March 31, 2008 and $40,000 for the three months ended March 31, 2007, representing an increase of $77,000, or 193%. This expense relates to corporate income taxes, primarily from our Taiwan branch, which was more profitable this quarter.

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Liquidity and Capital Resources

As of March 31, 2008, we had $16.0 million of cash, cash equivalents and investments compared to $15.0 million at December 31, 2007. These totals include $1,050,000 of restricted cash at March 31, 2008 and December 31, 2007. This restricted cash secures our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital at March 31, 2008 was $8.3 million compared to $14.7 million at December 31, 2007. The decrease in working capital was primarily due to reclassifying our auction rate securities, or ARS, from short-term investments to long-term investments on our balance sheet as of March 31, 2008.

Our investments consist of ARS, which are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long term they are generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed). We have investments in ARS valued at $7,975,000 as of March 31, 2008 which have failed at auction. These investments are illiquid and we are unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is subject to either a successful auction process, redemption of the investment, or a sale of the security in a secondary market. The failed ARS carry AAA ratings and continue to pay interest according to the stated terms. As of March 31, 2008, we have reclassified the balance of our failed ARS on the balance sheet from short-term investments to long-term investments due to the uncertainty in timing of liquidating these investments.

During the three months ended March 31, 2008, operating activities provided cash of $1.0 million attributable to our net income of $1.0 million and non-cash expenses of $521,000, offset by certain working capital items. During the three months ended March 31, 2007, operating activities provided cash of $591,000 attributable to our net income of $638,000 and non-cash expenses of $336,000, offset by certain working capital items.

During the three months ended March 31, 2008, investing activities provided cash of $1.2 million of cash attributable to $1.3 million in maturities of short-term investments, offset by $101,000 used to purchase capital equipment. During the three months ended March 31, 2007, investing activities utilized $1.0 million of cash attributable to a net $1.1 million invested in short-term investments and $96,000 used to purchase capital equipment, partially offset by $150,000 received as a result of a reduction of our restricted cash.

Financing activities generated $33,000 in cash during the three months ended March 31, 2008 and $348,000 in cash during the three months ended March 31, 2007 as a result of employees exercise of stock options.

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

Potential Cash Commitments

We have the following future or potential cash commitments:

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

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decreases on the straight-line basis over the length of our ten-year headquarters lease.

In December 2007, we entered into an agreement with Solidcore Systems, Inc. (Solidcore) to be the exclusive distributor of Solidcore s S3 Control Embedded software to OEMs in North America. This agreement commits us to pay minimum license fees of $800,000 to Solidcore by December 31, 2008, regardless of our sales of that software. As of March 31, 2008, we have paid $240,000 toward this commitment.

Recently Issued Accounting Standards

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. We adopted SFAS 159 effective January 1, 2008 which did not have a significant impact on our financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133. This statement is intended to enhance the current disclosure framework in Statement 133. The Statement requires enhanced disclosures about an entity s derivative and hedging activities and thereby improves the transparency of financial reporting. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 and is not expected to have a material impact on our financial position or results of operations.

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Item 4. Controls and Procedures

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

There has been no change in our internal control over financial reporting during the three months ended March 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

IPO Litigation

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

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

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

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

Item 1A. Risk Factors

The following risk factors and other information in this quarterly report on Form 10-Q and also those discussed in our annual report on Form 10-K for the year-ended December 31, 2007 should be carefully considered. The risks and uncertainties described below and discussed in our most recent annual report on Form 10-K are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected. We do not repeat risk factors that were disclosed in our most recent annual report on Form 10-K 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 as necessary where changes or updates are deemed significant and will add new risk factors not previously disclosed in our most recent annual report on Form 10-K as they become pertinent to our business. To the extent a risk factor is no longer considered relevant that was described in our most recent annual report on Form 10-K, it will be deleted in the annual report on Form 10-K to be filed for the year ending December 31, 2008.

General Business-Related Risk Factors

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

We have investments in ARS valued at $7,975,000 as of March 31, 2008 which have failed at auction. As a result, these investments are illiquid and we are unable to determine with any certainty when or if these investments will become liquid. Liquidity of these investments is subject to either a successful auction process, redemption of the investment, or a sale of the security in a secondary market. The potential lack of liquidity in our ARS investments has adversely affected our liquidity and working capital and could affect our future ability to fund our strategic and other initiatives. A decline in the value of these ARS or continued lack of liquidity could result in losses and have a material negative impact on our operating results and financial condition.

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Item 6. Exhibits

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

SIGNATURES

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

BSQUARE CORPORATION
(Registrant)

Date: May 8, 2008

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

Date: May 8, 2008

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

BSQUARE CORPORATION
INDEX TO EXHIBITS

Exhibit Number (Referenced to Item 601 of Regulation S-K)	Exhibit Description
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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