

BSQUARE CORP /WA
Form 10-Q
May 15, 2017
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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 March 31, 2017

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 | 91-1650880 |
| (State or other jurisdiction of | (I.R.S. Employer |
| incorporation or organization) | Identification No.) |
| 110 110 th Avenue NE, Suite 300, | |
| Bellevue WA | 98004 |
| (Address of principal executive offices) | (Zip Code) |

(425) 519-5900

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(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

(Do not
check if a
smaller
reporting
company)

Non-accelerated filer

Smaller reporting company

Emerging growth
company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 April 28, 2017: 12,569,043

BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended March 31, 2017

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

| | March 31, 2017 (Unaudited) | December 31, 2016 |
|---|----------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 9,704 | \$ 14,312 |
| Short-term investments | 21,280 | 18,888 |
| Accounts receivable, net of allowance for doubtful accounts of \$50 at March 31, 2017 and December 31, 2016 | 15,751 | 21,579 |
| Prepaid expenses and other current assets | 1,474 | 878 |
| Contract assets | 883 | — |
| Total current assets | 49,092 | 55,657 |
| Equipment, furniture and leasehold improvements, net | 1,040 | 1,089 |
| Deferred tax assets | 7 | 7 |
| Intangible assets, net | 439 | 464 |
| Goodwill | 3,738 | 3,738 |
| Other non-current assets including contract assets | 87 | 53 |
| Total assets | \$ 54,403 | \$ 61,008 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Third-party software fees payable | \$ 9,111 | \$ 14,831 |
| Accounts payable | 372 | 283 |
| Accrued compensation | 1,786 | 2,008 |
| Other accrued expenses | 806 | 714 |
| Deferred rent, current portion | 327 | 321 |
| Deferred revenue | 1,908 | 2,064 |
| Total current liabilities | 14,310 | 20,221 |
| Deferred tax liability | — | 23 |
| Deferred rent | 772 | 854 |
| Deferred revenue | 115 | 1,798 |
| 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; 12,568,708 shares issued and | | |
| outstanding at March 31, 2017 and 12,532,348 | | |
| shares issued and outstanding at December 31, | | |
| 2016 | 136,150 | 135,660 |
| Accumulated other comprehensive loss | (928) | (941) |
| Accumulated deficit | (96,016) | (96,607) |
| Total shareholders' equity | 39,206 | 38,112 |
| Total liabilities and shareholders' equity | \$ 54,403 | \$ 61,008 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

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

| | Three Months Ended | |
|--|-----------------------|----------|
| | March 31, 2017 | 2016 |
| Revenue: | | |
| Software | \$19,451 | \$20,167 |
| Professional engineering service | 3,390 | 5,272 |
| Total revenue | 22,841 | 25,439 |
| Cost of revenue: | | |
| Software | 14,114 | 17,161 |
| Professional engineering service | 2,474 | 3,982 |
| Total cost of revenue | 16,588 | 21,143 |
| Gross profit | 6,253 | 4,296 |
| Operating expenses: | | |
| Selling, general and administrative | 4,865 | 3,206 |
| Research and development | 1,347 | 441 |
| Total operating expenses | 6,212 | 3,647 |
| Income from operations | 41 | 649 |
| Other income, net | 55 | 21 |
| Income before income taxes | 96 | 670 |
| Income tax benefit (expense) | 106 | (170) |
| Net income | \$202 | \$500 |
| Basic income per share | \$0.02 | \$0.04 |
| Diluted income per share | \$0.02 | \$0.04 |
| Shares used in calculation of income per share: | | |
| Basic | 12,550 | 12,102 |
| Diluted | 12,848 | 12,531 |
| Comprehensive income: | | |
| Net income | \$202 | \$500 |
| Other comprehensive income: | | |
| Foreign currency translation, net of tax | (7) | 21 |
| Change in unrealized gains (losses) on investments, net of tax | 5 | (25) |
| Total other comprehensive income | (2) | (4) |
| Comprehensive income | \$200 | \$496 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

| | Three Months Ended | |
|--|-----------------------|----------|
| | March 31, 2017 | 2016 |
| Cash flows from operating activities: | | |
| Net income | \$202 | \$500 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 153 | 151 |
| Stock-based compensation | 399 | 413 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 5,078 | (2,314) |
| Contract assets, current | 203 | — |
| Prepaid expenses and other assets | (617) | (30) |
| Third-party software fees payable | (5,720) | 256 |
| Accounts payable and accrued expenses | (41) | (624) |
| Deferred revenue | (1,804) | (393) |
| Deferred rent | (76) | (71) |
| Net cash used in operating activities | (2,223) | (2,112) |
| Cash flows from investing activities: | | |
| Purchases of equipment and furniture | (83) | (38) |
| Proceeds from maturities of short-term investments | 9,750 | 6,450 |
| Purchases of short-term investments | (12,146) | (8,438) |
| Net cash used in investing activities | (2,479) | (2,026) |
| Cash flows provided by financing activities—proceeds | | |
| from exercise of stock options | 91 | 58 |
| Effect of exchange rates on cash | 3 | (21) |
| Net decrease in cash and cash equivalents | (4,608) | (4,101) |
| Cash and cash equivalents, beginning of period | 14,312 | 16,443 |
| Cash and cash equivalents, end of period | \$9,704 | \$12,342 |

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2017

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of BSQUARE Corporation (“BSQUARE”) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting and include the accounts of BSQUARE and our wholly owned subsidiaries. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of March 31, 2017, our operating results for the three months ended March 31, 2017 and 2016 and our cash flows for the three months ended March 31, 2017 and 2016. The accompanying financial information as of December 31, 2016 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2016. All intercompany balances have been eliminated.

Recently Adopted Accounting Standards

In March 2016, the Financial Accounting Standards Board (“FASB”) amended the existing accounting standards for stock-based compensation by issuing Accounting Standards Update (“ASU”) 2016-09 “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting” (“ASU 2016-09”). The changes in the new standard eliminate the requirements that excess tax benefits be recognized in additional paid-in capital and tax deficiencies be recognized either in the income tax provision or in additional paid-in capital, in addition to changing the accounting for forfeitures and presentation changes for cash flows. We adopted the amendments in the first quarter of 2017.

ASU 2016-09 requires that certain amendments be applied using a modified retrospective transition method by means of a cumulative effect adjustment to retained earnings as of the beginning of 2017. As a result of this adoption, we adjusted beginning retained earnings by \$3,200 at the beginning of 2017 for amendments related to an entity-wide accounting policy election to recognize share-based award forfeitures as they occur rather than at vest date. We will continue to apply an estimated forfeiture rate. There was no change to retained earnings with respect to unrecognized excess tax benefits as this was not applicable to us. We have elected to present any excess tax benefits for share-based payments in net operating cash rather than in net financing cash on the cash flow statement on a prospective transition method, and no prior periods have been adjusted.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers,” amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The amended guidance, herein referred to as Topic 606, is effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted for public companies effective for annual and interim reporting periods beginning after December 15, 2016. We have elected to early adopt Topic 606, effective January 1, 2017, using the modified retrospective transition method. We recognized the cumulative effect of applying the new revenue standard as an adjustment to the opening balance of retained earnings at the beginning of 2017. The comparative information has not been restated and continues to be reported under the accounting standards in effect for the period presented.

See Note 2 – Revenue Recognition, for additional accounting policy and transition disclosures.

Recently Issued Accounting Standards

In February 2016, the FASB issued ASU No. 2016-2, “Leases,” to make leasing activities more transparent and comparable, requiring most leases be recognized by lessees on their balance sheets as right-of-use assets, along with corresponding lease liabilities. ASU 2016-2 is effective for public business entities for annual periods beginning after December 31, 2018 and interim periods within that year, with early adoption permitted. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,” adding or clarifying guidance on the classification of certain cash receipts and payments in the statement of cash flows. The standard addresses eight specific cash flow issues with the objective of reducing diversity in practice. ASU 2016-15 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment,” simplifying how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. ASU 2017-04 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, with early adoption permitted on testing dates after January 1, 2017. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

Income Per Share

We compute basic income per share using the weighted average number of common shares outstanding during the period, and exclude any dilutive effects of common stock equivalent shares, such as options, restricted stock awards and restricted stock units. We consider restricted stock awards (“RSAs”) as outstanding and include them in the computation of basic income per share when underlying restrictions expire and the awards are no longer forfeitable. We consider restricted stock units (“RSUs”) as outstanding and include them in the computation of basic income per share only when vested. We compute diluted income per share using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock method. We exclude common stock equivalent shares from the computation if their effect is anti-dilutive.

We excluded 1,160,015 options for the three months ended March 31, 2017 from diluted income per share because their effect was anti-dilutive. In a period where we are in a loss position, we compute diluted loss per share using the basic share count. We excluded 633,309 options for the three months ended March 31, 2016 from diluted income per share because their effect was anti-dilutive.

2. Revenue Recognition

On January 1, 2017, we adopted Topic 606 applying the modified retrospective method to all contracts that were not completed as of January 1, 2017. Results for reporting periods beginning after January 1, 2017 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. We recorded a net reduction to opening equity of \$404,000 as of January 1, 2017 due to the cumulative impact of adopting Topic 606. The impact to revenues for the three months ended March 31, 2017 was an increase of \$2.8 million as a result of adopting Topic 606.

The adoption of Topic 606 did not have a significant impact on our third-party software or professional engineering services revenue; however, it did have a significant impact on our proprietary DataV software products. We executed our first two DataV contracts in the fourth quarter of 2016. Our current DataV contracts include customization, software license and support and maintenance performance obligations. Under the accounting standards in effect in the prior period, revenues from our DataV software contracts were recognized under a zero profit model whereby revenue was recognized up to the amount of costs incurred. The profit margin was deferred and recognized ratably over the service and maintenance period after delivery and acceptance of the software product. Under Topic 606, revenue is recognized on our DataV contracts when the customization services essential to provide the derived benefit of the software to the customer are completed and control of the product is transferred to the customer as evidenced by customer acceptance. During the three month period ended March 31, 2017, we received customer acceptance on a DataV software license, resulting in the recognition of \$2.8 million in revenue for the software license and customization services.

Changes in accounting policies as a result of adopting Topic 606 and nature of goods

The following is a description of principal activities from which we generate revenue. Revenues are recognized when control of the promised goods or services are transferred to our customers, in an amount that reflects the consideration that we expect to receive in exchange for those goods or services. We generate all of our revenue from contracts with customers.

Third-Party Software:

We sell third-party software licenses based upon a customer purchase order, shipping a certificate of authenticity (“COA”) to satisfy this single performance obligation. These shipments are also subject to limited return rights; historically, returns have averaged less than one-quarter of one percent. In accordance with Topic 606, we will continue to recognize revenue from third-party products at the time of shipment when the customer accepts control of the COA.

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Proprietary Software:

We sell our proprietary software products to customers under a contract or by purchase order. Our DataV software contracts generally include professional services, a perpetual or term license and support and maintenance. In contracts with multiple performance obligations, we identify each performance obligation and evaluate whether the performance obligations are distinct within the context of the contract at contract inception. Performance obligations that are not distinct at contract inception are combined. Contracts that include software customization may result in the combination of the customization services with the software license as one distinct performance obligation. The transaction price is generally in the form of a fixed fee at contract inception. Certain DataV contracts also include variable consideration in the form of royalties earned when customers meet contractual volume thresholds. We allocate the transaction price to each distinct performance obligation based on the estimated standalone selling price for each performance obligation. We then look to how control transfers to the customer in order to determine the timing of revenue recognition. In contracts that include customer acceptance, we recognize revenue when we have delivered the software and received customer acceptance. We recognize revenues from support and maintenance performance obligations over the service delivery period. We recognize revenues from royalties in the period of usage.

Our non-DataV software products generally do not include customization or modification services and are sold in the form of term licenses. These software licenses represent one performance obligation. Revenue is recognized when the software is delivered to the customer.

There are two items involving revenue recognition on DataV software contracts that require us to make more difficult and subjective judgments: the determination of which performance obligations are distinct within the context of the overall contract and the estimated standalone selling price of each performance obligation. In instances where our DataV contracts include significant customization or modification services, the customization and modification services are generally combined with the software license and recorded as one distinct performance obligation. We estimate the standalone selling price of each performance obligation based on either a cost plus margin approach or an adjusted market assessment approach. In instances where we have observable selling prices for professional services and support and maintenance, we may apply the residual approach to estimate the standalone selling price of software licenses.

Professional Engineering Services

We enter into contracts for professional engineering services that include software development and customization. We identify each performance obligation in our professional engineering services contracts at contract inception. The contracts generally include project deliverables specified by each customer. The performance obligations in the agreements are generally combined into one deliverable. The contract pricing is either at stated billing rates per service hour and material costs or at a fixed amount. Services provided under professional engineering agreements generally result in the transfer of control over time. The underlying deliverable is owned and controlled by the customer and does not create an asset with an alternative use to us. We recognize revenue on service contracts based on time and materials as we have the right to invoice. We recognize revenue on fixed fee contracts on the proportion of labor hours expended to the total hours expected to complete the contract performance obligation. Certain professional engineering contracts include substantive customer acceptance provisions. In contracts that include substantive customer acceptance provisions, we recognize revenue upon customer acceptance.

The determination of the total labor hours expected to complete the performance obligations involves significant judgment. In certain situations, when it is impractical for us to reasonably measure the outcome of a performance obligation, and where we anticipate that we will not incur a loss, an adjusted cost based input method is used for revenue recognition. Equal amounts of revenue and cost are recognized during the contract period, and profit is recognized when the project is completed and accepted.

Disaggregation of revenue:

The following table provides information about disaggregated revenue by primary geographical market, major product line and timing of revenue recognition, and includes a reconciliation of the disaggregated revenue with reportable segments (in thousands):

| | Three Months Ended | | | | |
|---|----------------------|----------------------|------------------|-----------------------------------|------------------|
| | March 31, 2017 | | | | |
| | Third Party Software | Proprietary Software | Total Software | Professional Engineering Services | Total |
| Primary geographical markets | | | | | |
| North America | \$ 16,296 | \$ 2,645 | \$ 18,941 | \$ 2,829 | \$ 21,770 |
| Europe | 424 | — | 424 | 398 | 822 |
| Asia | 77 | 9 | 86 | 163 | 249 |
| Total | \$ 16,797 | \$ 2,654 | \$ 19,451 | \$ 3,390 | \$ 22,841 |
| Major products/services lines | | | | | |
| Third-party software | \$ 16,797 | \$ — | \$ 16,797 | \$ — | \$ 16,797 |
| Proprietary software | — | 2,654 | 2,654 | — | 2,654 |
| Professional engineering services | — | — | — | 3,390 | 3,390 |
| | \$ 16,797 | \$ 2,654 | \$ 19,451 | \$ 3,390 | \$ 22,841 |
| Timing of revenue recognition | | | | | |
| Products transferred at a point in time | \$ 16,797 | \$ 2,654 | \$ 19,451 | \$ 590 | \$ 20,041 |
| Products and services transferred over time | — | — | — | 2,800 | 2,800 |
| | \$ 16,797 | \$ 2,654 | \$ 19,451 | \$ 3,390 | \$ 22,841 |

Contract balances:

The following table provides information about receivables, contract assets and contract liabilities from contracts with customers (in thousands):

| | As of |
|--|----------------|
| | March 31, 2017 |
| Receivables | \$ 15,751 |
| Short-term contract assets | 883 |
| Long-term contract assets | 31 |
| Short-term contract liabilities (deferred revenue) | 1,908 |
| Long-term contract liabilities (deferred revenue) | 115 |

We receive payments from customers based upon contractual billing schedules; accounts receivable are recorded when the right to consideration becomes unconditional. Contract assets include amounts related to our contractual right to consideration for completed performance objectives not yet invoiced, and also includes deferred contract acquisition costs, which will be amortized along with the associated revenue. Contract liabilities include payments received in advance of performance under the contract, and are realized with the associated revenue recognized under the contract. We had no asset impairment charges related to contract assets in the period.

Significant changes in the contract assets and the contract liabilities balances during the period are as follows (in thousands):

| | Three Months Ended | |
|---|--------------------|-----------------------|
| | March 31, 2017 | |
| | Contract Assets | Contract Liabilities* |
| Revenue recognized that was included in the contract liability (def. revenue) balance at Jan. 1, 2017 | \$— | \$ 2,627 |
| Increases due to cash received, excluding amounts recognized as revenue during the period | — | 929 |
| Transferred to receivables from contract assets recognized at January 1, 2017 | 752 | — |
| Performance obligations satisfied in previous periods | — | — |

* Comprised of Deferred Revenue

Contract acquisition costs:

In connection with the adoption of Topic 606, we are required to capitalize certain contract acquisition costs consisting primarily of commissions paid when contracts are signed. As of January 1, 2017, the date we adopted Topic 606, we capitalized \$292,000 in contract acquisition costs related to contracts that were not completed. For contracts that have a duration of less than one year, we follow a Topic 606 practical expedient and expense these costs when incurred; for contracts with life exceeding one year, as is more common with our DataV software bookings, we record these costs in proportion to each completed contract performance obligation. In the three months ended March 31, 2017, the amount of amortization was \$141,000 and there was no impairment loss in relation to costs capitalized.

Transaction price allocated to the remaining performance obligations

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The estimated revenues do not include amounts of variable consideration attributable to royalties or unexercised contract renewals (in thousands):

| | Remainder | | |
|-----------------------------------|-----------|-------|------|
| | of 2017 | 2018 | 2019 |
| Third-party software | \$ 109 | \$110 | \$36 |
| Proprietary software | 1,794 | 470 | 196 |
| Professional engineering services | 246 | — | — |

Practical Expedients and Exemptions

We generally expense sales commissions when incurred because the amortization period would have been less than one year. We record these costs within selling, general and administrative expenses.

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In accordance with Topic 606, the disclosure of the impact of adoption to our condensed consolidated statements of income and balance sheets was as follows:

| | Three months ended March 31, 2017 | | |
|--|--|--|---------------------------------|
| | Impact of changes in accounting policies | | |
| | As | Balances without adoption of Topic 606 | Effect of Change Higher/(Lower) |
| (in thousands, except per share amounts) | Reported | 606 | |
| Revenue: | | | |
| Software | \$ 19,451 | \$ 17,138 | \$ 2,313 |
| Professional engineering service | 3,390 | 2,944 | 446 |
| Total revenue | 22,841 | 20,082 | 2,759 |
| Cost of revenue: | | | |
| Software | 14,114 | 14,114 | — |
| Professional engineering service | 2,474 | 2,150 | 324 |
| Total cost of revenue | 16,588 | 16,264 | 324 |
| Gross profit | 6,253 | 3,818 | 2,435 |
| Operating expenses: | | | |
| Selling, general and administrative | 4,865 | 4,724 | 141 |
| Research and development | 1,347 | 1,347 | — |
| Total operating expenses | 6,212 | 6,071 | 141 |
| Income from operations | 41 | (2,253) | 2,294 |
| Net income (loss) | \$ 202 | \$(2,092) | \$ 2,294 |
| Basic income(loss) per share | \$ 0.02 | \$(0.17) | \$ 0.19 |
| Diluted income (loss) per share | \$ 0.02 | \$(0.17) | \$ 0.19 |
| | | | |
| | March 31, 2017 | | |
| | As | Balances without adoption of Topic 606 | Effect of Change Higher/(Lower) |
| (in thousands) | Reported | 606 | |
| Assets: | | | |
| Contract Assets | \$ 883 | \$ 904 | \$ (21) |
| Liabilities: | | | |
| Deferred revenue - current | 1,908 | 3,047 | (1,139) |
| Deferred revenue - noncurrent | 115 | 1,332 | (1,217) |
| Shareholders' Equity: | | | |
| Accumulated deficit | (96,016) | (98,352) | 2,336 |

3. Cash, Cash Equivalents and Investments

Cash, cash equivalents and short-term investments consisted of the following (in thousands):

| | March 31, 2017 | December 31, 2016 |
|---|----------------------|-------------------------|
| Cash | \$8,740 | \$ 11,016 |
| Cash equivalents: | | |
| Money market funds | 964 | 2,796 |
| Corporate commercial paper | — | 500 |
| Total cash equivalents | 964 | 3,296 |
| Total cash and cash equivalents | 9,704 | 14,312 |
| Short-term investments: | | |
| Corporate commercial paper | 10,149 | 11,465 |
| Corporate debt securities | 11,131 | 7,423 |
| Total short-term investments | 21,280 | 18,888 |
| Total cash, cash equivalents and short-term investments | \$30,984 | \$ 33,200 |

Gross unrealized gains and losses on our short-term investments were not material as of March 31, 2017 and December 31, 2016.

4. Fair Value Measurements

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

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

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

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

We classify our cash equivalents and short-term investments within Level 1 or Level 2 because our cash equivalents and short-term investments are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs.

Assets and liabilities measured at fair value on a recurring basis as of March 31, 2017 and December 31, 2016 are summarized below (in thousands):

| March 31, 2017 | Total |
|---------------------------------|-------|
| Quoted Prices in Active Markets | |
| Direct or Indirectly Observable | |

for Inputs
(Level 2)
Identical
Assets

(Level
1)

| | | | |
|-------------------------------------|-------|-----------|----------|
| Assets | | | |
| Cash equivalents: | | | |
| Money market funds | \$964 | \$ — | \$964 |
| Total cash equivalents | 964 | — | 964 |
| Short-term investments: | | | |
| Corporate commercial paper | — | 10,149 | 10,149 |
| Corporate debt securities | — | 11,131 | 11,131 |
| Total short-term investments | — | 21,280 | 21,280 |
| Total assets measured at fair value | \$964 | \$ 21,280 | \$22,244 |

| | December 31, 2016 | | |
|--|--|---------------------|-----------------|
| | Quoted Prices in | | |
| | Active Markets for Direct or Indirect Identical Assets Observable | | |
| | (Level 1) | Inputs (Level 2) | Total |
| Assets | | | |
| Cash equivalents: | | | |
| Money market funds | \$2,796 | \$ — | \$2,796 |
| Corporate commercial paper | — | 500 | 500 |
| Total cash equivalents | 2,796 | 500 | 3,296 |
| Short-term investments: | | | |
| Corporate commercial paper | — | 11,465 | 11,465 |
| Corporate debt securities | — | 7,423 | 7,423 |
| Total short-term investments | — | 18,888 | 18,888 |
| Total assets measured at fair value | \$2,796 | \$ 19,388 | \$22,184 |

5. Goodwill and Intangible Assets

Goodwill was originally recorded in connection with the September 2011 acquisition of MPC Data, Ltd. (renamed BSQUARE EMEA, Ltd. in 2015), a United Kingdom based provider of software engineering services. The excess of the acquisition consideration over the fair value of net assets acquired was recorded as goodwill and is included within the professional engineering services reporting unit. There were no changes in the carrying amount of goodwill during the three months ended March 31, 2017.

Intangible assets relate to customer relationships that we acquired from TestQuest, Inc. in November 2008 and from the acquisition of BSQUARE EMEA, Ltd. in September 2011.

Information regarding our intangible assets is as follows (in thousands):

| | March 31, 2017 | | |
|------------------------|----------------|--------------|----------|
| | Gross | | Net |
| | Carrying | Accumulated | Carrying |
| | Amount | Amortization | Value |
| Customer relationships | \$1,275 | \$ (836) | \$ 439 |

December 31, 2016

| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
|------------------------|-----------------------------|-----------------------------|--------------------------|
| Customer relationships | \$1,275 | \$ (811) | \$ 464 |

Amortization expense was \$25,000 for the three months ended March 31, 2017, and \$34,000 for the three months ended March 31, 2016. Amortization in future periods is expected to be as follows (in thousands):

| | |
|-------------------|-------|
| Remainder of 2017 | \$74 |
| 2018 | 98 |
| 2019 | 98 |
| 2020 | 98 |
| 2021 | 71 |
| Total | \$439 |

6. Credit Agreement

Line of Credit

On September 22, 2015, we entered into a two-year unsecured line of credit agreement (the “Credit Agreement”) with JPMorgan Chase Bank, N.A. (the “Bank”) in the principal amount of up to \$12 million. On September 29, 2016, the Credit Agreement was modified to extend the final due date an additional year to September 22, 2018. At our election, advances under the Credit Agreement shall bear interest at either (1) a rate per annum equal to 1.5% below the bank’s applicable prime rate or (2) 1.5% above the Bank’s applicable LIBOR rate, in each case as defined in the Credit Agreement. The Credit Agreement contains customary affirmative and negative covenants, including compliance with financial ratios and metrics, as well as limitations on our ability to pay distributions or dividends while there is an ongoing event of default or to the extent such distribution causes an event of default. We are required to maintain certain minimum interest coverage ratios, liquidity levels and asset coverage ratios as defined in the Credit Agreement. We were in compliance with all such covenants as of March 31, 2017.

There were no amounts outstanding under the Credit Agreement as of March 31, 2017 or December 31, 2016. In September 2016, we entered into a new letter of credit agreement for \$250,000 secured by the Credit Agreement in connection with the lease of our corporate headquarters. Accordingly, the principal amount available under the Credit Agreement has been reduced from \$12 million to \$11.75 million.

7. Shareholders’ Equity

Equity Compensation Plans

We have a stock plan (the “Stock Plan”) and an inducement stock plan for newly hired employees (the “Inducement Plan”) (collectively, the “Plans”). Under the Plans, stock options to purchase shares of our common stock may be granted with a fixed exercise price that is equal to the fair market value of our common stock on the date of grant. These options have a term of up to 10 years and vest over a predetermined period, generally four years. Incentive stock options granted under the Stock Plan may only be granted to our employees. The Plans also allow for awards of non-qualified stock options, stock appreciation rights, RSAs and unrestricted stock awards, and RSUs. Expense is recorded for performance options over the requisite service periods when achievement of related performance targets are considered to be probable.

Stock-Based Compensation

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

Three
Months
Ended

| | March 31, | |
|-------------------------|-----------|-------|
| | 2017 | 2016 |
| Dividend yield | 0 % | 0 % |
| | 3.3 | 3.4 |
| Expected life | years | years |
| Expected volatility | 53 % | 55 % |
| Risk-free interest rate | 1.7 % | 1.1 % |

The impact on our results of operations from stock-based compensation expense was as follows (in thousands, except per share amounts):

| | Three Months Ended | |
|--|--------------------------|--------|
| | March 31, | |
| | 2017 | 2016 |
| Cost of revenue — service | \$65 | \$138 |
| Selling, general and administrative | 284 | 249 |
| Research and development | 50 | 26 |
| Total stock-based compensation expense | \$399 | \$413 |
| Per diluted share | \$0.03 | \$0.03 |

Stock Option Activity

The following table summarizes stock option activity under the Plans for the three-month period ended March 31, 2017:

| | Number of | Weighted | | |
|---|-----------|----------|------------|-------------|
| | | Exercise | Life | Intrinsic |
| | Shares | Price | (in years) | Value |
| Stock Options | | | | |
| Balance at January 1, 2017 | 1,846,768 | \$ 4.84 | 8.19 | \$2,138,361 |
| Granted | 39,500 | 5.59 | | |
| Exercised | (21,412) | 4.11 | | |
| Forfeited | (32,130) | 5.09 | | |
| Expired | (4,573) | 5.89 | | |
| Balance at March 31, 2017 | 1,828,153 | \$ 4.86 | 8.06 | \$1,513,726 |
| Vested and expected to vest at March 31, 2017 | 1,677,043 | \$ 4.81 | 7.94 | \$1,473,638 |
| Exercisable at March 31, 2017 | 815,565 | \$ 4.20 | 6.64 | \$1,200,208 |

At March 31, 2017, total compensation cost related to stock options granted but not yet recognized was \$1,471,547, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.59 years. The following table summarizes certain information about stock options:

| | Three Months Ended | |
|--|--------------------|-----------|
| | March 31, 2017 | 2016 |
| Weighted-average grant-date fair value of option | | |
| grants for the period | \$3.01 | \$3.06 |
| Options in-the-money at period end | 1,224,182 | 1,338,733 |
| Aggregate intrinsic value of options exercised | \$40,421 | \$49,330 |

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

Restricted Stock Unit Activity

The following table summarizes RSU activity for the three-month period ended March 31, 2017:

| | Weighted | |
|---------------------------------------|-----------|-----------------|
| | Average | |
| | Number of | Grant Date Fair |
| | Shares | Value |
| Unvested at January 1, 2017 | 119,606 | \$ 5.60 |
| Granted | — | — |
| Vested | (15,839) | 5.72 |
| Forfeited | — | — |
| Unvested at March 31, 2017 | 103,767 | \$ 5.58 |
| Expected to vest after March 31, 2017 | 89,585 | \$ 5.60 |

At March 31, 2017, total compensation cost related to RSUs granted but not yet recognized was \$276,481, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.46 years.

Common Stock Reserved for Future Issuance

The following table summarizes our shares of common stock reserved for future issuance under the Plans as of March 31, 2017:

| | |
|---|-----------|
| Stock options outstanding | 1,828,153 |
| RSUs outstanding | 103,767 |
| Stock awards available for future grant | 686,363 |
| Common stock reserved for future issuance | 2,618,283 |

8. Commitments and Contingencies

Lease and rent obligations

Our commitments include obligations outstanding under operating leases, which expire through 2020. We have lease commitments for office space in Bellevue, Washington; Boston, Massachusetts; Taipei, Taiwan; Tokyo, Japan; and Trowbridge, UK. We also lease office space on a month-to-month basis in Akron, Ohio.

In August 2013, we amended the lease agreement for our Bellevue, Washington headquarters, and extended the term of the original lease that was scheduled to expire in August 2014 to May 2020.

Rent expense was \$260,000 for each of the three-month periods ended March 31, 2017 and 2016.

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

| | |
|-------------------|---------|
| Remainder of 2017 | \$999 |
| 2018 | 1,163 |
| 2019 | 1,038 |
| 2020 | 437 |
| Total commitments | \$3,637 |

Loss Contingencies

From time to time, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business including tax assessments. We defend ourselves vigorously against any such claims. When (i) it is probable that an asset has been impaired or a liability has been incurred and (ii) the amount of the loss can be reasonably estimated, we record the estimated loss. We provide disclosure in the notes to the consolidated financial statements for loss contingencies that do not meet both of these conditions if there is a reasonable possibility that a loss may have been incurred that would be material to the financial statements. Significant judgment is required to determine the probability that a liability has been incurred and whether such liability is reasonably estimable. We base accruals made on the best information available at the time, which can be highly subjective. The final outcome of these matters could vary significantly from the amounts included in the accompanying consolidated financial statements.

9. Information about Geographic Areas and Operating Segments

Our chief operating decision-makers (i.e., our Chief Executive Officer and certain direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information for purposes of allocating

resources and evaluating financial performance. There are no segment managers who are held accountable by our chief operating decision-makers, or anyone else, for operations, operating results, or planning for levels or components below the consolidated unit level. We operate within a single industry segment of computer software and services. We have two major product lines, software and professional engineering services, each of which we consider to be an operating and reportable segment. Software includes third-party software and proprietary software sales, and professional engineering services includes consulting, programming and software customization and implementation revenue. We do not allocate costs other than direct cost of goods sold to the segments or produce segment income statements. We do not produce asset information by reportable segment and it is not presented here. The following table sets forth profit and loss information about our segments (in thousands):

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| | Three Months Ended | |
|--|-----------------------|----------|
| | March 31, | |
| | 2017 | 2016 |
| Software | | |
| Revenue | \$19,451 | \$20,167 |
| Cost of revenue | 14,114 | 17,161 |
| Gross profit | 5,337 | 3,006 |
| Professional Engineering Services | | |
| Revenue | 3,390 | 5,272 |
| Cost of revenue | 2,474 | 3,982 |
| Gross profit | 916 | 1,290 |
| Total gross profit | 6,253 | 4,296 |
| Operating expenses | 6,212 | 3,647 |
| Other income, net | 55 | 21 |
| Income tax benefit (expense) | 106 | (170) |
| Net income | \$202 | \$500 |

Revenue by geography is based on the sales region of the customer. The following tables set forth revenue and long-lived assets by geographic area (in thousands):

| | Three Months Ended | |
|-----------------------|-----------------------|----------|
| | March 31, | |
| | 2017 | 2016 |
| Total revenue: | | |
| North America | \$21,770 | \$24,067 |
| Asia | 249 | 275 |
| Europe | 822 | 1,097 |
| Total revenue | \$22,841 | \$25,439 |

| | March 31, | December 31, |
|---------------------------|--------------|-----------------|
| | 2017 | 2016 |
| Long-lived assets: | | |
| North America | \$989 | \$ 1,025 |
| Asia | 90 | 90 |
| Europe | 4,232 | 4,236 |
| Total long-lived assets | \$5,311 | \$ 5,351 |

10. Significant Risk Concentrations

Significant Customer

Honeywell International, Inc. and affiliated entities (“Honeywell”) accounted for \$3.3 million, or 15% of total revenue for the three months ended March 31, 2017 and for \$4.2 million, or 16% total revenue, for the three months ended March 31, 2016. PACCAR Inc. and affiliated entities accounted for \$3.0 million, or 13% of total revenue for the three months ended March 31, 2017. No other customers accounted for 10% or more of our total revenue for the periods noted above.

At March 31, 2017, Honeywell had total accounts receivable balance of \$8.2 million, or approximately 52% of total accounts receivable, and had \$7.1 million, or approximately 33% of total accounts receivable at December 31, 2016. No other customer accounted for 10% or more of the total accounts receivable at March 31, 2017 or December 31, 2016.

Significant Supplier

We have two OEM Distribution Agreements (“ODAs”) with Microsoft Corporation (“Microsoft”) which enable us to sell Microsoft Windows Embedded operating systems on a non-exclusive basis to our customers in the United States, Canada, Argentina, Brazil, Chile, Columbia, Mexico, Peru, Puerto Rico, the Caribbean (excluding Cuba), the European Union, the European Free Trade Association, Turkey and Africa, which expire on June 30, 2018. We also have four ODAs with Microsoft, which allow us to sell Microsoft Windows Mobile operating systems in the Americas (excluding Cuba), Japan, Taiwan, Europe, the Middle East, and Africa, which also expire on June 30, 2018.

Software sales under these agreements constitute a significant portion of our software revenue and total revenue. These agreements are typically renewed bi-annually, annually or semi-annually; however, there is no automatic renewal provision in any of these agreements. Further, these agreements can be terminated unilaterally by Microsoft at any time. Microsoft currently offers a rebate program to sell Microsoft Windows Embedded operating systems pursuant to which we earn money for achieving certain predefined objectives. In accordance with Microsoft rebate program rules, we allocate 30% of rebate values to reduce cost of sales, with the remaining 70% to offset qualified marketing expenses in the period the expenditures are incurred.

Under this rebate program, we recognized \$110,000 of rebate credits during the three months ended March 31, 2017, compared to \$86,000 during the three months ended March 31, 2016, which were accounted for as reductions in cost of sales. Additionally, during the three months ended March 31, 2017, we received \$155,000 in rebates, compared to \$201,000 during the three months ended March 31, 2016, which were accounted for as reductions in marketing expenses. There was a balance of approximately \$256,000 in outstanding rebate credits for which we qualified at March 31, 2017, which will be accounted for as reductions in marketing expense in the period in which qualified program expenditures are made.

Microsoft implemented significant pricing changes for its embedded products, including ending its design registration pricing discounts, terminating its OVRP and changing the aggregate volume price structure and product royalties for existing embedded Windows products effective January 1, 2016. In December 2015, Microsoft granted extensions for certain of the OVRPs through December 31, 2016, at which time the program ended.

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

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our condensed consolidated financial statements and related notes. Some statements and information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In some cases, readers can identify forward-looking statements by terms such as "may," "will," "should," "expect," "plan," "intend," "forecast," "anticipate," "believe," "estimate," "predict," "potential," "continue," or the negative of or other comparable terminology, which when used are meant to signify the statement as forward-looking. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and situations that are difficult to predict and that may cause our own, or our industry's actual results, to be materially different from the future results that are expressed or implied by these statements. Accordingly, actual results may differ materially from those anticipated or expressed in such statements as a result of a variety of factors, including those discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2016 entitled "Risk Factors," similar discussions in subsequently filed Quarterly Reports on Form 10-Q, including this Form 10-Q, as applicable, and those contained from time to time in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

Overview

BSQUARE Corporation ("BSQUARE") was incorporated in Washington State in July 1994. Since our inception, our business has largely been focused on providing software solutions (historically including reselling software from Microsoft Corporation ("Microsoft")) and related engineering services to businesses that develop, market and sell dedicated purpose standalone intelligent systems. Examples of dedicated purpose standalone intelligent systems include smart, connected computing devices such as smart phones, set-top boxes, point-of-sale terminals, kiosks, tablets and handheld data collection devices, as well as smart vending machines, ATM machines, digital signs and in-vehicle telematics and entertainment devices. We focus on systems that utilize various Microsoft Windows Embedded operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX, and that are usually connected to a network or data cloud via a wired or wireless connection. Our customers include world-class original equipment manufacturers ("OEMs"), original design manufacturers ("ODMs"), corporate enterprises ("Enterprises"), silicon vendors ("SVs") and peripheral vendors. A significant portion of our business historically has also been focused on reselling software from Microsoft, from which a majority of our revenue currently continues to be derived.

Beginning in 2014, we initiated development efforts focused on new proprietary software products addressing the Internet of Things ("IoT") market, which is the interconnection of uniquely identifiable embedded computing devices within the existing internet infrastructure. These software development efforts have driven a new business initiative for BSQUARE, which we refer to as DataV™. Our DataV solution includes software products and services that are designed to render raw IoT device data into meaningful and actionable data for our customers. We launched DataV in early 2016 and announced our first three major customer bookings during 2016.

Critical Accounting Judgments

Management's discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales, cost of sales and expenses and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Except for policy changes in accounting for revenues associated with our adoption of Topic 606 (see Note 2 "Revenue Recognition" in the Notes to Condensed Consolidated Financial Statements in Item 1), there have been no significant changes to our critical accounting judgments, policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2016.

Results of Operations

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

| | Three Months Ended | |
|-------------------------------------|---------------------------------------|-------|
| | March 31, 2017 2016 (unaudited) | |
| Revenue: | | |
| Software | 85 % | 79 % |
| Professional engineering service | 15 % | 21 % |
| Total revenue | 100 % | 100 % |
| Cost of revenue | 73 % | 83 % |
| Gross profit | 27 % | 17 % |
| Operating expenses: | | |
| Selling, general and administrative | 21 % | 13 % |
| Research and development | 6 % | 2 % |
| Total operating expenses | 27 % | 15 % |
| Income from operations | 0 % | 2 % |
| Other income, net | 0 % | 0 % |
| Income before income taxes | 0 % | 2 % |
| Income tax benefit (expense) | 1 % | 0 % |
| Net income | 1 % | 2 % |

Revenue

We generate revenue from the sale of software, both our own proprietary software and third-party software that we resell, and the sale of professional engineering services. Total revenue decreased by \$2.6 million, or 10%, to approximately \$22.8 million for the three months ended March 31, 2017, from approximately \$25.4 million in the year-ago period. This decrease was primarily due to lower sales of Windows Mobile and Embedded operating systems and a decrease in professional engineering services revenue, partially offset by recognition of approximately \$3.0 million in DataV software and professional engineering services revenue. Revenue from customers outside of North America decreased \$0.3 million, or 22%, to \$1.1 million for the three months ended March 31, 2017, compared to \$1.4 million in the year-ago period due primarily to lower professional engineering services revenue in Europe.

Software revenue

Software revenue consists of sales of third-party software and revenue realized from the sales of our own proprietary software products, which include software license sales, support and maintenance revenue. Software revenue was as follows (dollars in thousands):

| | Three Months Ended | |
|--|------------------------|--|
| | March 31, 2017 2016 | |

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(unaudited)

| | | | | |
|---|----------|----------|----|---|
| Software revenue: | | | | |
| Third-party software | \$16,797 | \$19,917 | | |
| Proprietary software | 2,654 | 250 | | |
| Total software revenue | \$19,451 | \$20,167 | | |
| Software revenue as a percentage of total revenue | 85 | % | 79 | % |
| Third-party software revenue as a percentage of total | | | | |
| software revenue | 86 | % | 99 | % |

The vast majority of our third-party software revenue is comprised of sales of Microsoft Windows Embedded and Windows Mobile operating systems.

Third-party software revenue decreased \$3.1 million, or 16%, to \$16.8 million for the three months ended March 31, 2017, from \$19.9 million in the year-ago period. The decline is primarily due to lower sales of Windows Embedded and Windows Mobile operating systems in the current period, a portion of which is attributable to higher levels of buying activity late in 2016 as customers anticipated higher pricing following the cessation of Microsoft's volume purchase discount programs on December 31, 2016.

Sales of Microsoft operating systems represented approximately 72% of our total revenue and 40% of our total gross margin for the three months ended March 31, 2017 and approximately 77% of our total revenue and 63% of our total gross margin for the three months ended March 2016.

Proprietary software revenue increased approximately \$2.4 million to \$2.7 million for the three months ended March 31, 2017, from \$250,000 in the year-ago period due primarily to recognition of \$2.5 million in revenue since we delivered and received customer acceptance on a DataV software license, resulting in recognition of revenue for customization services and the software license. We expect that revenues from both DataV and our other proprietary software will continue to fluctuate in timing and amount in future periods in 2017. We anticipate that our DataV revenues will grow over time, but that other proprietary software product sales will decline over time as they approach the end of their life cycles.

Professional engineering service revenue

Professional engineering service revenue was as follows (dollars in thousands):

| | Three Months Ended | |
|---|--------------------|---------|
| | March 31, 2017 | 2016 |
| | (unaudited) | |
| Professional engineering service revenue | \$3,390 | \$5,272 |
| Professional engineering service revenue as a percentage of total revenue | 15 % | 21 % |

Professional engineering service revenue decreased \$1.9 million, or 36%, for the three months ended March 31, 2017, from the year-ago period due to decreases in service revenue generated in each of our three geographic areas: North America, Asia and EMEA. The decreases in North America and EMEA service revenue were due to the completion in 2016 of several existing customer projects and a shift in our sales generation priorities and staffing to DataV. The decrease in Asia was due to lower revenue generated by sales in Japan. Our largest professional engineering services customers in the first quarter of 2017 were Google, Coca-Cola and Mitsubishi Electric Corporation.

Gross profit and gross margin

Cost of software revenue consists primarily of the cost of third-party software products payable to third-party vendors and support costs associated with our proprietary software products. Cost of service revenue consists primarily of salaries and benefits, contractor costs and re-billable expenses, related facilities and depreciation costs, and amortization of certain intangible assets related to acquisitions.

Gross profit on the sale of third-party software products is also positively affected by rebate credits we receive from Microsoft for the sale of Windows Embedded operating systems earned through the achievement of defined objectives. Our largest professional engineering customers in 2016 were Google, Coca-Cola and Mitsubishi Electric Corporation.

Under the Microsoft rebate program, we recognized \$110,000 and \$86,000 of rebate credits during the three months ended March 31, 2017 and 2016, respectively, which were accounted for as reductions in cost of sales. We received

\$155,000 and \$201,000 in rebates during the three months ended March 31, 2017 and 2016, respectively, which were accounted for as reductions in marketing expense. There was a balance of \$256,000 in outstanding rebate credits for which we qualified as of March 31, 2017, which will reduce marketing expense if and when qualified program expenditures are made.

Gross profit and related gross margin were as follows (dollars in thousands):

| | Three Months Ended | | | |
|---|--------------------|---|---------|---|
| | March 31, 2017 | | 2016 | |
| | (unaudited) | | | |
| Software gross profit | \$5,337 | | \$3,006 | |
| Third-party software gross margin | 16 | % | 14 | % |
| Proprietary software gross margin | 99 | % | 56 | % |
| Software gross margin | 27 | % | 15 | % |
| Professional engineering service gross profit | \$916 | | \$1,290 | |
| Professional engineering service gross margin | 27 | % | 24 | % |
| Total gross profit | \$6,253 | | \$4,296 | |
| Total gross margin | 27 | % | 17 | % |

Software gross profit and gross margin

Software gross profit increased \$2.3 million or 78% for the three months ended March 31, 2017, from the year-ago period. Our software gross margin increased by twelve percentage points to 27% for the three months ended March 31, 2017 compared to the year-ago period. The increase in software gross profit was driven by recognition of \$2.5 million in DataV software revenue. We anticipate that software gross margin will fluctuate in future periods due to the timing of DataV software revenue recognition.

Third-party software gross margin increased to 16% for the three months ended March 31, 2017 compared to 14% in the year-ago period primarily due to higher margins on Windows Embedded operating systems associated with volume rebates.

Proprietary software gross margin was 99% for the three months ended March 31, 2017, compared to 56% in the year-ago period, with the increase due to recognition of \$2.5 million in DataV software revenue.

Professional engineering service gross profit and gross margin

Professional engineering service gross profit decreased by \$0.4 million, or 29%, for the three months ended March 31, 2017 from the year-ago period, and service gross margin increased by three percentage points to 27% for the three months ended March 31, 2017 compared to the year-ago period. The decrease in service gross profit primarily resulted from the \$1.9 million decrease in service revenue for the three months ended March 31, 2017 compared to the prior year period. The increase in gross margin was primarily due to higher utilization of professional engineering personnel.

Operating expenses

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and related benefits, commissions and bonuses for our sales, marketing and administrative personnel and related facilities and depreciation costs, as well as professional services fees (e.g., consulting, legal, audit and tax). SG&A expenses increased by approximately \$1.7 million, or 52%, to \$4.9 million for the three months ended March 31, 2017, from \$3.2 million in the year-ago period as a result of higher spending in sales and marketing expenses to support the launch of our DataV products and increased general and administrative spending. SG&A expenses represented 21% of our total revenue for the three months ended March 31, 2017, and 13% for the three months ended March 31, 2016.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs and related facilities and depreciation costs. R&D expenses increased by \$906,000 to \$1,347,000 for the three months ended March 31, 2017, from \$441,000 in the year-ago period, due to increased spending for continued development of our DataV product line. R&D expenses represented 6% of our total revenue for the three months ended March 31, 2017, and 2% of our total revenue for the three months ended March 31, 2016.

Other income (expense), net

Other income (expense) consists primarily of interest income on our cash and investments, gains and losses we may recognize on our investments, gains and losses on foreign exchange transactions and other items. Other income, net, increased by \$34,000 to \$55,000 for the three months ended March 31, 2017, compared to \$21,000 in the year-ago period. The change was primarily due to higher interest income in the current year period resulting from higher prevailing interest rates and higher average invested balances.

Income tax (benefit) expense

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Income tax benefit was \$106,000 for the three months ended March 31, 2017, compared to income tax expense of \$170,000 in the year-ago period, a change of \$276,000. The tax benefit for the period ended March 31, 2017 was related to discrete items, including U.K. stock compensation tax benefits, a U.K. net operating loss carryback and an international tax reserve release. The tax expense for the period ended March 31, 2016 was related to U.S. alternative minimum tax, U.K. tax expense and a discrete increase in the Japan valuation allowance on deferred tax assets.

Liquidity and Capital Resources

As of March 31, 2017, we had \$31.0 million of cash, cash equivalents and investments, compared to \$33.2 million at December 31, 2016, reflecting a net use of \$2.2 million in cash during the quarter.

Net cash used in operating activities was \$2.2 million for the three months ended March 31, 2017, comprised of our net income of \$0.2 million, a \$5.7 million decrease in third-party software fees payable, a \$0.6 million increase in prepaid assets and a \$1.8 million decrease in deferred revenue, offset by a \$5.1 million decrease in accounts receivable. Net cash used in operating activities was \$2.1 million for the three months ended March 31, 2016, driven primarily by net income of \$0.5 million, offset by a \$0.3 million decrease in third-party software fees payable and a \$2.3 million increase in net accounts receivable. These changes include the impact of the cumulative effect adjustment at January 1, 2017 relating to adoption of new accounting rules.

Investing activities used cash of \$2.5 million for the three months ended March 31, 2017, due to a net increase in short-term investments of \$2.4 million, and capital expenditures of \$83,000. Investing activities used cash of \$2.0 million for the three months ended March 31, 2016, due to a \$2.0 million net increase in short-term investments and capital expenditures of \$38,000.

Financing activities generated \$91,000 during the three months ended March 31, 2017, and \$58,000 during the three months ended March 31, 2016, as a result of the 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.

In September 2015, we entered into a two-year unsecured line of credit agreement (the "Credit Agreement") with JPMorgan Chase Bank, N.A. in the principal amount of up to \$12 million. In September 2016, the Credit Agreement was modified to extend the final due date an additional year to September 22, 2018. There were no amounts outstanding under the Credit Agreement as of March 31, 2017 or December 31, 2016. In September 2016, we entered into a new letter of credit agreement for \$250,000 secured by the Credit Agreement in connection with the lease of our corporate headquarters. Accordingly, the principal amount available under the Credit Agreement has been reduced from \$12 million to \$11.75 million. See Note 6, "Credit Agreement" in the Notes to Condensed Consolidated Financial Statements in Item 1 for more information regarding the Credit Agreement.

Cash Commitments

We have the following future or potential cash commitments:

• Minimum rents payable under operating leases total \$1.0 million for the remainder of 2017, \$1.2 million in 2018, \$1.0 million in 2019 and \$0.4 million in 2020.

Recently Issued Accounting Standards

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk
Not applicable.

Item 4. Controls and Procedures

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

There were no changes in our internal control over financial reporting during the three-month period ended March 31, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the risk factors set forth in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2016.

Item 5. Other Information

None.

Item 6. Exhibits

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

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 15, 2017 By: /s/ Peter J. Biere
Peter J. Biere
Chief Financial Officer, Secretary and Treasurer

BSQUARE CORPORATION

INDEX TO EXHIBITS

| Exhibit Number | Description | Filed or Furnished Incorporated by Reference | | | |
|-------------------|---|---|----------------|-------------------|-----------|
| | | Herewith | Form Date | Filing Exhibit | File No. |
| 3.1 | Amended and Restated Articles of Incorporation | | S-1 8/17/1998 | 3.1 (a) | 333-85351 |
| 3.1(a) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 10-Q 8/7/2000 | 3.1 | 000-27687 |
| 3.1(b) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 8-K 10/11/2005 | 3.1 | 000-27687 |
| 3.2 | Bylaws and all amendments thereto | | 10-K 3/19/2003 | 3.2 | 000-27687 |
| 10.1 | Employment Letter Agreement with David Wagstaff dated September 23, 2016 | X | | | |
| 10.2 | Employment Letter Agreement with Scott Caldwell dated February 23, 2017 | X | | | |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 | X | | | |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 | X | | | |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | |
| 101.SCH | XBRL Taxonomy Extension Schema | X | | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase | X | | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase | X | | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase | X | | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase | X | | | |

