BSQUARE CORP /WA
Form 10-Q
November 05, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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 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 x No ¨

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

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

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

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

The number of shares of common stock outstanding as of October 30, 2009: 10,135,832

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BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended September 30, 2009

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EXPLANATORY NOTE

The unaudited financial information for the nine months ended September 30, 2008 contained in this Quarterly Report on Form 10-Q has been restated as discussed in Note 2 of the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, and also in Note 8 of the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Our Annual Report on Form 10-K for the year ended December 31, 2008 restated our consolidated financial statements for the fiscal year ended December 31, 2007, for each of the quarterly periods within the fiscal year ended December 31, 2007, and for the first and second quarterly periods of the fiscal year ended December 31, 2008. We have not individually amended our previously filed Annual Report on Form 10-K for the fiscal year ended December 31, 2007, or any of our Quarterly Reports on Form 10-Q for the quarterly periods of the fiscal year ended December 31, 2007. In addition, we have not individually amended our previously filed Quarterly Reports on Form 10-Q for the first and second quarterly periods of the fiscal year ended December 31, 2008. Accordingly, our financial statements for these periods, and all related earnings press releases and communications relating to these periods, that were released prior to the filing of our Annual Report on Form 10-K for the year ended December 31, 2008 on March 26, 2009, should not be relied upon. The unaudited financial information for the nine months ended September 30, 2008 contained in this Quarterly Report on Form 10-Q reflects the restated information as discussed in Note 2 of the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, and also in Note 8 of the Condensed Consolidated Financial Statements included in this Quarterly Report on this Form 10-Q.

The following sections in this Quarterly Report on Form 10-Q include restated information for the nine months ended September 30, 2008:

Part I:

Item 1 Financial Statements

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

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	September 30, 2009 (Unaudited)	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,475	$ 7,703
Accounts receivable, net of allowance for doubtful accounts of $195 at September 30, 2009 and $198 at December 31, 2008	12,092	10,726
Prepaid expenses and other current assets	675	703
Total current assets	23,242	19,132
Long-term investments	4,199	4,679
Equipment, furniture and leasehold improvements, net	796	981
Intangible assets, net	1,639	1,975
Restricted cash	900	900
Other non-current assets	90	91
Total assets	$ 30,866	$ 27,758
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,046	$ 2,925
Other accrued expenses	4,242	3,057
Accrued compensation	1,592	1,636
Accrued legal fees		534
Deferred revenue	1,492	355
Total current liabilities	10,372	8,507
Deferred rent	329	309
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; 10,135,096 shares issued and outstanding at September 30, 2009 and 10,082,654 shares issued and outstanding at December 31, 2008	123,292	122,660
Accumulated other comprehensive loss	(786)	(1,048)
Accumulated deficit	(102,341)	(102,670)
Total shareholders equity	20,165	18,942
Total liabilities and shareholders equity	$ 30,866	$ 27,758

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008 (as restated, see Note 8)
Revenue:				
Software	$ 9,876	$ 8,716	$ 25,999	$ 29,392
Service	6,523	7,486	23,191	19,294
Total revenue	16,399	16,202	49,190	48,686
Cost of revenue:				
Software	7,561	6,747	19,598	22,983
Service (1)	5,436	5,022	17,353	13,008
Total cost of revenue	12,997	11,769	36,951	35,991
Gross profit	3,402	4,433	12,239	12,695
Operating expenses:				
Selling, general and administrative (1)	2,426	3,006	8,821	8,998
Research and development (1)	906	622	3,208	1,827
Total operating expenses	3,332	3,628	12,029	10,825
Gain on sale of patents		300		300
Income from operations	70	1,105	210	2,170
Interest and other income, net	22	58	126	306
Income before income taxes	92	1,163	336	2,476
Income tax expense	(21)	(16)	(7)	(143)
Net income	$ 71	$ 1,147	$ 329	$ 2,333
Basic income per share	$ 0.01	$ 0.11	$ 0.03	$ 0.23
Diluted income per share	$ 0.01	$ 0.11	$ 0.03	$ 0.23
Shares used in calculation of income per share:				
Basic	10,126	10,039	10,108	10,009
Diluted	10,265	10,103	10,244	10,251

(1) Includes the following amounts related to stock-based compensation expense:

Cost of revenue service	$	68	$	94	$	210	$	321
Selling, general and administrative		107		250		389		717
Research and development		10		14		23		59
Total stock-based compensation expense	$	185	$	358	$	622	$	1,097

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008 (as restated, see Note 8)
Cash flows from operating activities:		
Net income	$ 329	$ 2,333
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of patents		(300)
Depreciation and amortization	705	403
Stock-based compensation	622	1,097
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,355)	(1,741)
Prepaid expenses and other assets	31	(251)
Accounts payable and accrued liabilities	1,262	462
Reversal of accrued legal fees	(534)	
Deferred revenue	1,137	30
Deferred rent	20	(18)
Net cash provided by operating activities	2,217	2,015
Cash flows from investing activities:		
Purchases of equipment and furniture	(139)	(557)
Proceeds from reduction of restricted cash		150
Capitalized costs associated with TestQuest acquisition	(43)	
Maturities of investments	700	3,050
Net cash provided by investing activities	518	2,643
Cash flows from financing activities:		
Proceeds from exercises of stock options	10	104
Net cash provided by financing activities	10	104
Effect of exchange rate changes on cash	27	19
Net increase in cash and cash equivalents	2,772	4,781
Cash and cash equivalents, beginning of period	7,703	4,377
Cash and cash equivalents, end of period	$ 10,475	$ 9,158

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2009

(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 September 30, 2009 and its operating results and cash flows for the three and nine months ended September 30, 2009 and 2008. The accompanying financial information as of December 31, 2008 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 provisions 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, 2008. All intercompany balances have been eliminated.

Recently Issued Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*. The FASB Accounting Standards Codification (the Codification), which was launched on July 1, 2009, became the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP), superseding various existing authoritative accounting pronouncements. The Codification effectively eliminates the GAAP hierarchy contained in SFAS No. 162 and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. SFAS No. 168 was effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company s adoption of SFAS No. 168 had no effect on its consolidated financial statements, other than changes to references to GAAP Statements within the consolidated financial statements.

In September 2009, the FASB issued new accounting guidance related to the revenue recognition of multiple element arrangements. The new guidance states that if vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, companies will be required to develop a best estimate of the selling price to separate deliverables and allocate arrangement consideration using the relative selling price method. The accounting guidance will be applied prospectively and will become effective during the first quarter of 2011. Early adoption is allowed. The Company is currently evaluating the impact of this accounting guidance on its consolidated financial statements.

In September 2009, the FASB issued new accounting guidance related to certain revenue arrangements that include software elements. Previously, companies that sold tangible products with more than incidental software were required to apply software revenue recognition guidance. This guidance often delayed revenue recognition for the delivery of the tangible product. Under the new guidance, tangible products that have software components that are essential to the functionality of the tangible product will be excluded from the software revenue recognition guidance. The new guidance will include factors to help companies determine what is essential to the functionality. Software-enabled products will now be subject to other revenue guidance and will likely follow the guidance for multiple deliverable arrangements issued by the FASB in September 2009. The new guidance is to be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with earlier application permitted. If a vendor elects earlier application and the first reporting period of adoption is not the first reporting period in the vendor s fiscal year, the guidance must be applied through retrospective application from the beginning of the vendor s fiscal year and the vendor must disclose the effect of the change to those previously reported periods. The adoption of this accounting guidance will not have an impact on the Company s consolidated financial statements.

Subsequent Events

The Company has evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through November 5, 2009, the day the financial statements were issued.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

Income Per Share

Basic income 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 income per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock and if-converted method in the case of stock options and warrants, respectively. Restricted stock and restricted stock units are considered outstanding and included in the computation of both the basic and diluted income per share. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive. Shares excluded from the calculation of diluted income per share because the effect would have been anti-dilutive were 1,312,000 and 1,835,000 for the three and nine months ended September 30, 2009, respectively, and 834,000 and 532,000 for the three and nine months ended September 30, 2008, respectively.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Weighted average shares outstanding for basic income per share	10,126	10,039	10,108	10,009
Dilutive effect of common stock equivalent shares	139	64	136	242
Weighted average shares outstanding for diluted income per share	10,265	10,103	10,244	10,251

For additional information on the Company s accounting policies, see Item 8 of Part II, Financial Statements Note 1 Description of Business and Accounting Policies in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

2. Investments

The Company s long-term investments consist entirely of auction rate securities (ARS). ARS are securities whose interest or dividend rate was historically reset through a Dutch Auction process, usually every 7, 28 or 35 days. ARS historically trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS were issued and rated as long-term, they were generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holders to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market. These investments are currently illiquid and the Company is unable to determine with any certainty when these investments will become liquid. The liquidity of these investments is contingent on redemption of the investments by the issuers, settlement by the underwriters and/or secondary offerors, or sales of the securities in a secondary market. Redemptions of the Company s ARS portfolio balance were $525,000 and $700,000 for the three and nine months ended September 30, 2009, respectively.

The Company accounts for certain assets and liabilities at fair value. The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. The Company categorizes each of its fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are::

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.

Historically, the fair value of the Company s ARS approximated par value due to the frequent resets through the auction process. While the ARS continue to earn interest at the maximum contractual rate, there is no active market for these investments, and therefore these investments do not currently have a readily determinable market value.

Due to the lack of observable market quotes on the ARS, the fair value measurements have been estimated using Level 3 inputs. The fair value was based on factors that reflect assumptions market participants would use in pricing, including, among others: relevant future market conditions including those that are based on the expected cash flow streams, the underlying financial condition and credit quality of the issuer, and the maturity of the securities, as well as the market activity of similar securities.

The Company obtained an independent valuation of its ARS as of September 30, 2009, and determined the fair value to be $4.2 million, as compared to par value of $4.9 million. As a result, the Company has adjusted the carrying value of its ARS downward by $726,000 as of September 30, 2009. Of this amount, $378,000 was deemed to be other-than-temporary during the three months ended

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

December 31, 2008, and was recorded as a charge to interest and other income, net during that period. The remainder of the valuation allowance has been deemed to be temporary and recorded in accumulated other comprehensive loss. Factors considered in determining whether a loss is temporary include the length of time and extent to which the investment s fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company s intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

ARS have been classified as long-term investments due to the uncertainty as to when these investments will be liquidated.

The following table presents the Company s fair value hierarchy for its financial assets measured at fair value on a recurring basis as of September 30, 2009:

	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	$	$	$ 3,707	$ 3,707
Closed-end funds			370	370
Corporate collateral			122	122
Total auction rate securities	$	$	$ 4,199	$ 4,199

The following table reconciles the beginning and ending balances for the Company s ARS using significant unobservable inputs (Level 3) (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3):			
	Student Loan Backed	Closed-end Funds	Corporate Collateral	Total
Balance at December 31, 2008	$ 3,603	$ 954	$ 122	$ 4,679
Redemptions at par	(25)	(675)		(700)
Reversal of unrealized loss due to sale of security	2	56		58
Unrealized gains included in accumulated other comprehensive loss	127	35		162
Balance at September 30, 2009	$ 3,707	$ 370	$ 122	$ 4,199

3. Intangible Assets

Intangible assets relate to customer relationships, trade names, trademarks and technology acquired from TestQuest, Inc. in November 2008 and from NEC Corporation of America in December 2007. The following table presents the Company s gross carrying value of the acquired intangible assets subject to amortization and accumulated amortization thereof (in thousands):

	September 30, 2009	December 31, 2008
Gross carrying value of the acquired intangible assets subject to amortization	$ 2,158	$ 2,115
Accumulated amortization	(519)	(140)
Net book value	$ 1,639	$ 1,975

As of September 30, 2009, 83% of the gross carrying value represents acquired technology while 80% of the net book value represents acquired technology. Amortization expense was $122,000 and $379000 for the three and nine months ended September 30, 2009, respectively, and $22,000 and $67,000 for the three and nine months ended September 30, 2008, respectively. Amortization in future periods is expected to be as follows (in thousands):

Remainder of 2009	$ 128
2010	463
2011	334
2012	331
2013	278
Thereafter	105
Total	$ 1,639

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

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, non-qualified stock options may be granted with a fixed exercise price that is typically fair market value on the date of grant. These options have a term of up to 10 years and vest over a predetermined period, generally four years. Incentive stock options granted under the Amended Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted with an exercise price equal to the fair market value of the Company s stock on the date of grant. The Amended Plan was amended in 2003 to allow for an automatic annual increase in the number of shares reserved for issuance during each of the Company s fiscal years. Such automatic annual increase is in an amount equal to the lesser of: (i) four percent of the Company s outstanding shares at the end of the previous fiscal year, (ii) an amount determined by the Company s Board of Directors, or (iii) 375,000 shares. The Amended Plan was amended in 2005 to allow for awards of stock appreciation rights and restricted and unrestricted stock. The Amended Plan was further amended in 2007 to allow for awards of restricted stock units, and the currently effective version of the Amended Plan is the Third Amended and Restated Stock Plan.

In August 2009, the Board of Directors voted unanimously to terminate the Company s Non-Qualified Stock Option Plan. There were no grants made under the Non-Qualified Stock Option Plan at any time during its existence.

Restricted Stock and Restricted Stock Unit 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 generally subject to forfeiture for a period of two or four years.

Stock-Based Compensation

The Company records compensation expense associated with stock options and other forms of equity compensation using the straight-line method over the life of each vesting traunch of the awards. Compensation expense includes the impact of an estimate for forfeitures for all awards. The impact on the Company s results of operations of recording stock-based compensation expense for the three and nine months ended September 30, 2008 and 2009 was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Cost of revenue service	$ 68	$ 94	$ 210	$ 321
Selling, general and administrative	107	250	389	717
Research and development	10	14	23	59
Total stock-based compensation expense	$ 185	$ 358	$ 622	$ 1,097

Stock-based compensation expense reduced net income by $185,000 and diluted income per share by $0.02 for the three months ended September 30, 2009. Stock-based compensation expense reduced net income by $358,000 and diluted income per share by $0.04 for the three months ended September 30, 2008.

Stock-based compensation expense reduced net income by $622,000 and diluted income per share by $0.06 for the nine months ended September 30, 2009. Stock-based compensation expense under FASB 718 reduced net income by $1.1 million and diluted income per share by $0.11 for the nine months ended September 30, 2008.

At September 30, 2009, total compensation cost related to stock options granted under the Amended Plan but not yet recognized was $272,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.2 years and will be adjusted for subsequent changes in estimated forfeitures.

At September 30, 2009, total compensation cost related to restricted stock awards granted under the Amended Plan but not yet recognized was $41,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately six months.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

At September 30, 2009, total compensation cost related to restricted stock units granted under the Amended Plan but not yet recognized was $77,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately one year.

Key Assumptions

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	74%	74%	73%	78%
Risk-free interest rate	2.0%	2.9%	1.8%	2.8%
Estimated forfeitures	17%	21%	18%	22%

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 Amended Plan for the nine months ended September 30, 2009:

Stock Options	**Number of Shares**	**Weighted Average Exercise Price**	**Weighted Average Remaining**	**Aggregate Intrinsic Value**

				Contractual Life (in years)		
Outstanding at January 1, 2009	2,029,796	$	4.27			
Granted at fair value	40,900		2.16			
Exercised	(5,023)		2.05			
Forfeited	(49,028)		3.36			
Expired	(37,612)		7.09			
Outstanding at September 30, 2009	1,979,033	$	4.20	6.01	$	266,000
Vested and expected to vest at September 30, 2009	1,798,440	$	4.24	5.83	$	248,000
Exercisable at September 30, 2009	1,573,890	$	4.30	5.52	$	227,000

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 September 30, 2009. The Company issues new shares of common stock upon exercise of stock options.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Weighted-average grant-date fair value of option grants for the period	$ 1.73	$ 2.81	$ 1.33	2.91
Options in-the-money at period end	620,606	789,089	620,606	789,089
Aggregate intrinsic value of options exercised	$ 1,000	$ 8,000	$ 2,000	$ 88,000

Restricted Stock Activity

The following table summarizes restricted stock award activity under the Amended Plan for the nine months ended September 30, 2009:

	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2009	42,000	$ 4.29
Awarded	31,500	2.14
Released	(31,500)	4.74
Forfeited		
Outstanding at September 30, 2009	42,000	$ 2.34

The following table summarizes restricted stock unit activity under the Amended Plan for the nine months ended September 30, 2009:

	Number of Shares	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2009	72,763		
Awarded			
Released	(13,237)		
Forfeited	(8,185)		
Outstanding at September 30, 2009	51,341	.99	$ 133,000
Vested and expected to vest at September 30, 2009	31,542	.77	$ 82,000

5. Other Comprehensive Income (Loss)

Other comprehensive income (loss) refers to revenue, expenses, gains and losses that, under GAAP, are recorded as an element of shareholders equity and excluded from net income (loss). The Company s other comprehensive loss as of September 30, 2009, and December 31, 2008, is comprised of foreign currency translation adjustments, and unrealized gains and losses from its subsidiaries not using the U.S. dollar as their functional currency and unrealized losses on the Company s investments.

The components of other comprehensive income were as follows (in thousands):

	Three Months ended September 30,		Nine Months ended September 30,	
	2009	**2008**	**2009**	**2008**
Net unrealized gain (loss) on investments	$ 32	$ (466)	$ 220	$ (466)
Foreign currency translation gain (loss)	14	(83)	42	18
Other comprehensive income (loss)	$ 46	$ (549)	$ 262	$ (448)

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; Boston, Massachusetts; Chanhassen, Minnesota; Dallas, Texas; Vancouver, Canada; Taipei, Taiwan; Beijing, China and Tokyo, Japan. The Company leases office space in Akron, Ohio on a month-to-month basis.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

Under the terms of the Company s corporate headquarters lease signed in February 2004, the landlord has the ability to demand payment for cash payments forgiven in 2004 if the Company defaults under the lease. The amount of the forgiven payments for which the landlord could demand repayment was $1.2 million at September 30, 2009, and decreases on a straight-line basis over the term of the lease, which expires in 2014.

Rent expense was $369,000 for the three months ended September 30, 2009 and $287,000 for the three months ended September 30, 2008. Rent expense was $1.2 million for the nine months ended September 30, 2009 and $865,000 for the nine months ended September 30, 2008.

As of September 30, 2009, the Company had $900,000 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 September 30, 2009 were as follows (in thousands):

Operating leases:	
Remainder of 2009	$ 328
2010	1,096
2011	1,043
2012	1,079
2013	1,089
2014	770
Total commitments	$ 5,405

Legal Proceedings

IPO Litigation

In Summer and early Fall 2001, four 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. The operative complaint alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The suit purported 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 alleged 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 alleged 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 sought damages in an unspecified amount. 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.

The parties in the approximately 300 coordinated cases, including the Company, the underwriter defendants in its class action lawsuit, and the plaintiff class in its class action lawsuit, reached a settlement in early 2009. As part of the settlement, the insurers for the issuer defendants will make the entire settlement payment on behalf of the issuers, including us. On October 5, 2009, the Court granted final approval of the settlement.

A thirty day deadline to appeal the final approval order will start to run when the judgment is filed. Three objectors have already filed petitions to the Second Circuit seeking permission to appeal the District Court s final approval order on the basis that the settlement class is broader than the class previously rejected by the Second Circuit in its December 5, 2006 order vacating the District Court s order certifying classes in the focus cases. Following the Court s final approval of the settlement, the Company determined that it is unlikely that the Company will be liable for any damages that will not be paid for by the Company s insurance carriers, even in the unlikely event that any appeals are successful. As a result, it was determined that an accrued legal fees liability of $534,000 was no longer probable. Consequently, this liability was reversed, which resulted in a reduction of selling, general and administrative expense during the three months ended September 30, 2009. However, due to the inherent uncertainties of litigation, subsequent events could affect the assessment of this liability and this disclosure.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

7. Segment 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 September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Total revenue:				
North America	$ 15,052	$ 14,784	$ 46,798	$ 44,485
Asia	1,227	1,256	2,021	3,691
Other foreign	120	162	371	510
Total revenue (1)	$ 16,399	$ 16,202	$ 49,190	$ 48,686

	September 30, 2009	December 31, 2008
Long-lived assets:		
North America	$ 2,315	$ 2,808
Asia	120	148
Total long-lived assets	$ 2,435	$ 2,956

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

Significant Customer

The Ford Motor Company (Ford) accounted for $3.9 million, or 24%, of total revenue for the three months ended September 30, 2009, and $14.3 million, or 29%, of total revenue for the nine months ended September 30, 2009. No other customer accounted for 10% or more of total revenue for the three or nine months ended September 30, 2009. Ford accounted for $2.6 million, or 16%, of total revenue for the three months ended September 30, 2008, and $2.8 million, or 6% of total revenue for the nine months ended September 30, 2008. No other customer accounted for 10% or more of total revenue for the three or nine months ended September 30, 2008.

Ford had an accounts receivable balance of $4.6 million, or 38% of total accounts receivable, as of September 30, 2009. Approximately $1.4 million of this balance was past due as of September 30, 2009 and the remaining balance was current. Substantially all of the past due portion was collected subsequent to September 30, 2009. No other customer accounted for 10% or more of total accounts receivable as of September 30, 2009. Ford had an accounts receivable balance of $2.3 million, or 22% of total accounts receivable, as of September 30, 2008, and Microsoft Corporation had an accounts receivable balance of $1.1 million, or 11% of total accounts receivable, as of September 30, 2008. All receivable amounts as of September 30, 2008 for these significant customers were subsequently collected, and no other customer accounted for 10% or more of total accounts receivable as of September 30, 2008.

8. Restatement of Financial Information

On February 10, 2009, based on the recommendation of the Audit Committee, the Board of Directors determined that the Company should restate its consolidated financial statements for the fiscal year ended December 31, 2007, for each of the quarterly periods of fiscal year 2007, and for the first and second quarterly periods of fiscal year 2008. Accordingly, on February 11, 2009, the Company announced that its previously released financial statements for these periods, and all related earnings press releases and communications relating to these periods, should not be relied upon.

Background of the Restatement

In early February 2009, the Company identified a clerical error in its calculation of certain vendor volume discounts affecting third-party software cost of sales. Until September 1, 2008, this vendor offered the Company volume discounts based on the achievement of predetermined unit sales levels in a particular month. As this vendor s software was sold during the month, software cost of sales was recorded at a standard cost. As a result of the volume discounts offered by the vendor, it was necessary to adjust software cost of sales at month-end to reflect any volume purchase discounts earned once total unit sales volume for the month was known. The error caused software cost of sales to be understated.

The Board of Directors charged the Audit Committee with investigating the error and its causes. As part of its investigation, the Audit Committee interviewed persons who were available to it and who had performed or reviewed the calculation of the volume purchase discount, and reviewed pertinent email and other documents. The Audit Committee determined that a former employee, who had the responsibility for calculating the volume purchase discount from December 2006 through December 2007, began to incorrectly calculate the discount for a small number of this vendor s products. Another employee, who replaced the first employee, continued to make the same error from January through June 2008. The Audit Committee determined that the employees who supervised the two employees and reviewed their work had failed to detect the error.

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BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

The Audit Committee concluded that no current or prior officer of the Company, nor any of the Company s independent auditors, were aware of the error before it was discovered in early February 2009.

The clerical error impacted the fourth quarter of 2006, the 2007 fiscal year, and the first two quarters of 2008. The erroneous calculation ended in July 2008, and in September 2008 the vendor changed its pricing structure, which eliminated the future possibility for this error. As of December 31, 2008, the error had not been detected, so management has subsequently taken several actions to remediate the material weaknesses that existed at December 31, 2008. The effect on the fourth quarter of 2006 was deemed to be immaterial and has been included in the restated 2007 financial statements.

Correction of the error increased software cost of sales $164,000 for the nine months ended September 30, 2008 and had no effect for the three months ended September 30, 2008.

The following tables set forth condensed, restated financial data as originally reported, and as restated (in thousands, except per share data):

	Nine Months Ended September 30, 2008		
	As Reported	**Adjustments**	**As Restated**
Condensed Consolidated Statements of Income			
Total revenue	$ 48,686	$	$ 48,686
Total cost of revenue	35,827	164	35,991
Gross profit	12,859	(164)	12,695
Total operating expenses	10,825		10,825
Income from operations	2,334	(164)	2,170
Net income	2,497	(164)	2,333
Basic income per share	$ 0.25	$ (0.02)	$ 0.23
Diluted income per share	$ 0.24	$ (0.01)	$ 0.23

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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 similar 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 on Form 10-Q, and in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2008 entitled Risk Factors.

Overview

We provide software and engineering service offerings to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® CE) 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, handheld data collection devices, personal media players, smart phones and devices targeted at automotive applications. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile . However, with our acquisition of customers and rights to license Adobe Flash technology from NEC Corporation of America (NECAM) in December 2007 and our acquisition of certain assets from TestQuest Inc. (TestQuest) in November 2008, we now support customers building or supporting devices utilizing other operating systems such as Android, 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) and original design manufacturers (ODMs) who design, build and sell devices to their customers;
- Silicon vendors (SVs) who sell application processors to OEM s and ODM s; and
- Enterprises who are deploying devices to support their line of business operation.

OEMs and ODMs are the primary purchasers of our software products which they incorporate into their devices in order to enable certain functionality. For example, an ODM may purchase our SDIO middleware software in order to enable high-performance WiFi capability in their device while an OEM may purchase Adobe Flash technology from us to enable the playback of Flash content on the device. OEM, ODM, SV and Enterprise customers may purchase our TestQuest software in order to assist in the testing and validation of software running on their application processors (in the case of SV s) or their devices. Customers typically hire our engineering services organization to assist in the design, development, testing and deployment of their devices. Customers also hire our engineering services organization to assist them in deploying Adobe Flash technology into their devices and implementing TestQuest technology into their quality assurance processes.

Critical Accounting Judgments

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company s critical accounting policies as those that are most important to the portrayal of our financial condition and results of operations, and those that require us to make our most difficult and subjective judgments, often as a result of the need to make estimates related to matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are relevant to understanding our results. For additional information see Item 8 of Part II, Financial Statements Note 1 Description of Business and Accounting Policies, in our Annual Report on Form 10-K for the year ended December 31, 2008. 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.

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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. Periodically, we begin work on engineering service engagements prior to having a signed contract and, in some cases, the contract is signed in a quarter after which we start incurring service delivery costs. We do not defer costs associated with these uncontracted engagements as of quarter-end even though the underlying contract might be signed prior to us reporting our results.

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. Certain fixed-price and time and materials with cap engineering service contracts that require significant production, modification, or customization of software, are accounted for using the percentage-of-completion method. We use the percentage-of-completion method of accounting because it is the most preferable method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; in our case, it is a better measure of periodic income results than other methods and it better matches revenue recognized with the costs incurred. 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 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. We recognize royalty revenue, classified as software 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.

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. When evaluating the adequacy of the allowance for doubtful accounts, we consider many factors, including analysis of accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history. 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.

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Investments

Investments are reviewed quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. We also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Stock-Based Compensation

We record compensation expense associated with stock options and other forms of equity compensation using the straight-line method over the life of each vesting traunch of the awards. Compensation expense includes the impact of an estimate for forfeitures for all awards.

Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the countries and other jurisdictions 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 additional tax expense. Conversely, to the extent we determine that a valuation allowance is no longer necessary, it may result in a tax benefit. 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, or a portion thereof, 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. Consequently, we have continued to maintain a full valuation allowance on our deferred tax assets as of September 30, 2009.

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

Results of Operations

The following discussion includes the effects of the restatement as further described above in Note 8 of the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q. The effect of the restatement on the period-to-period analysis within this discussion was to increase software cost of sales $164,000 for the nine months ended September 30, 2008. The restatement had no further significant effect on the period-to-period analysis.

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 September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008 (1)
	(unaudited)		(unaudited)	
Revenue:				
Software	60%	54%	53%	60%
Service	40	46	47	40

Total revenue	100	100	100	100
Cost of revenue:				
Software	46	42	40	47
Service	33	31	35	27
Total cost of revenue	79	73	75	74
Gross profit	21	27	25	26

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	Three Months Ended September 30, 2009	2008	Nine Months Ended September 30, 2009	2008 (1)
Operating expenses:				
Selling, general and administrative	15	18	18	18
Research and development	6	4	7	4
Total operating expenses	21	22	25	22
Gain on Sale of Patents	0	2	0	0
Income from operations	0	7	0	5
Interest and other income, net	0	0	0	1
Income before income taxes	0	7	0	6
Income tax expense	0	0	0	0
Net income	0%	7%	0%	6%

(1) Restated. See Note 8 of the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for further discussion.

Comparison of the Three and Nine Months Ended September 30, 2009 and 2008

Revenue

Total revenue consists of sales of software and engineering services to the customer segments identified previously. Total revenue increased $197,000, or 1%, to $16.4 million during the three months ended September 30, 2009, from $16.2 million in the year ago period. Primarily this increase was due to higher sales of third party software, offset in part by a decline in service revenue.

Total revenue increased $504,000, or 1%, to $49.2 million for the nine months ended September 30, 2009, from $48.7 million in the year ago period. This increase was driven by higher service and proprietary software revenue, offset in part by lower third party software sales.

Software revenue

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, sales of our software development kits and smart device reference designs, and support and maintenance revenue, as well as royalties from certain engineering service contracts. Engineering service revenue is derived from hardware and software development activities, fees for customer training, and rebillable expenses.

Software revenue for the three and nine months ended September 30, 2009 and 2008 was as follows (dollars in thousands):

	Three months ended September 30, 2009	2008	Nine months ended September 30, 2009	2008
	(unaudited)		(unaudited)	
Software revenue:				
Third-party software	$ 8,929	$ 7,885	$ 22,907	$ 27,022
Proprietary software	947	831	3,092	2,370
Total software revenue	$ 9,876	$ 8,716	$ 25,999	$ 29,392

Software revenue as a percentage of total revenue	60%	54%	53%	60%
Third-party software revenue as a percentage of total software revenue	90%	90%	88%	92%

The vast majority of our third-party software revenue is comprised of the sale of Microsoft Embedded operating systems in North America. The single largest contributor to our proprietary software revenue was TestQuest product sales and associated maintenance and support revenue for the three and nine months ended September 30, 2009, Smartbuild software royalties for the three months ended September 30, 2008, and service contract royalties for the nine months ended September 30, 2008.

Third-party software revenue increased $1.0 million, or 13%, for the three months ended September 30, 2009, as compared to the year ago period. Growth in Microsoft licensing revenue due to improving economic conditions and one significant Flash Lite licensing transaction in the amount of $640,000 drove the increase.

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Third-party software revenue decreased $4.1 million, or 15%, for the nine months ended September 30, 2009, as compared to the year ago period. Poor economic conditions during the first six months of 2009 negatively affected our Microsoft licensing customer count, average order volume and resulting revenue and drove the decline. Further, the nine months ended September 30, 2008, benefited from a large $1.3 million customer order. Given the current economic conditions, it is difficult to estimate third-party software revenue for the remainder of 2009.

Proprietary software revenue increased $116,000, or 14%, for the three months ended September 30, 2009, as compared to the year ago period. This increase was driven by $273,000 in revenue associated with TestQuest products acquired in November 2008, offset in part by $262,000 in lower Smartbuild royalty revenue. Proprietary software revenue increased $722,000, or 30%, for the nine months ended September 30, 2009, as compared to the year ago period. This increase was primarily driven by $1.3 million in TestQuest product revenue, offset in part by a $752,000 decline in service contract royalty revenue as certain guaranteed minimum service contracts expired during 2008, and no agreements were entered into in the past year which generated significant royalty revenue during the nine months ended September 30, 2009. Given current economic conditions, it is difficult to estimate proprietary software revenue for the remainder of 2009.

Service revenue

Service revenue for the three and nine months ended September 30, 2009 and 2008 was as follows (dollars in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2009	**2008**	**2009**	**2008**
Service revenue	$ 6,523	$ 7,486	$ 23,191	$ 19,294
Service revenue as a percentage of total revenue	40%	46%	47%	40%

Service revenue In North America continues to be driven by engineering services performed for the Ford Motor Company (Ford), which accounted for 50% and 59% of total service revenue during the three and nine months ended September 30, 2009, respectively, and 33% and 14% for the three and nine months ended September 30, 2008, respectively. During the second quarter of 2009, we agreed with Ford to cap the fees of the current projects being performed, which resulted in a shift in accounting from time and material to the percentage-of-completion methodology for the remaining portion of the projects. During the three months ended September 30, 2009, the estimated hours to complete certain deliverables increased, and because the project fees are fixed, the amount of service revenue recognized during the third quarter was negatively affected. The effect of the fixed fee arrangement was a 39% reduction in the effective billing rate to Ford, as compared to the effective billing rate prior to the fee cap.

Service revenue decreased $963,000, or 13%, for the three months ended September 30, 2009 as compared to the year ago period. This decrease was primarily due to $656,000 in lower North America service revenue, as well as continued economic softness in the Asia Pacific (APAC) region, where service revenue declined $307,000 from the year ago period. Although Ford revenue in the third quarter of 2009 was negatively impacted by both the contract modification which occurred in the second quarter of 2009 and project overruns, service revenue attributable to Ford increased by $800,000 to $3.3 million during the three months ended September 30, 2009, compared to $2.5 million in the year ago period. The Ford-related increase was offset by a $1.3 million decline in non-Ford North American service revenue during the period, a result of a 23% lower effective billing rate, and a 14% decline in billed hours as poor economic conditions continue to have a negative effect on this market.