BSQUARE CORP /WA
Form 10-Q
August 13, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

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 300, 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 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

Non-accelerated filer (Do not check if a smaller reporting company) 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 July 31, 2018: 12,713,410

BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended June 30, 2018

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

| | June 30, 2018 (Unaudited) | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 10,238 | $ 12,859 |
| Short-term investments | 7,623 | 11,895 |
| Accounts receivable, net of allowance for doubtful accounts of $50 and $50 at June 30, 2018 and December 31, 2017, respectively | 16,219 | 18,014 |
| Contract assets | 923 | 937 |
| Prepaid expenses and other current assets | 511 | 548 |
| Total current assets | 35,514 | 44,253 |
| Equipment, furniture and leasehold improvements, less accumulated depreciation | 1,220 | 989 |
| Intangible assets, less accumulated amortization | 316 | 365 |
| Goodwill | 3,738 | 3,738 |
| Other non-current assets | 212 | 89 |
| Total assets | $ 41,000 | $ 49,434 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Third-party software fees payable | $ 9,619 | $ 10,547 |
| Accounts payable | 382 | 375 |
| Accrued compensation | 1,871 | 2,266 |
| Other accrued expenses | 745 | 681 |
| Deferred rent | 347 | 339 |
| Deferred revenue | 1,225 | 3,219 |
| Total current liabilities | 14,189 | 17,427 |
| Deferred rent, long-term | 340 | 516 |
| Deferred revenue, long-term | 836 | 61 |
| Shareholders' equity: | | |
| Preferred stock, no par: 10,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock, no par: 37,500,000 shares authorized; 12,712,134 and 12,664,489 issued and outstanding at June 30, 2018 and December 31, 2017, respectively | 137,932 | 137,622 |
| Accumulated other comprehensive loss | (904) | (916) |
| Accumulated deficit | (111,393) | (105,276) |
| Total shareholders' equity | 25,635 | 31,430 |
| Total liabilities and shareholders' equity | $ 41,000 | $ 49,434 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share amounts)

(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Revenue: | | | | |
| Third-party software | $16,992 | $15,505 | $33,056 | $32,302 |
| Proprietary software | 281 | 481 | 2,076 | 3,135 |
| Professional engineering service | 1,930 | 2,862 | 4,749 | 6,252 |
| Total revenue | 19,203 | 18,848 | 39,881 | 41,689 |
| Cost of revenue: | | | | |
| Third-party software | 14,480 | 13,103 | 27,834 | 27,185 |
| Proprietary software | 100 | 39 | 141 | 71 |
| Professional engineering service | 1,362 | 1,833 | 3,445 | 4,307 |
| Total cost of revenue | 15,942 | 14,975 | 31,420 | 31,563 |
| Gross profit | 3,261 | 3,873 | 8,461 | 10,126 |
| Operating expenses: | | | | |
| Selling, general and administrative | 4,901 | 5,046 | 10,349 | 9,911 |
| Research and development | 2,078 | 1,446 | 4,308 | 2,793 |
| Total operating expenses | 6,979 | 6,492 | 14,657 | 12,704 |
| Loss from operations | (3,718) | (2,619) | (6,196) | (2,578) |
| Other income, net | 47 | 59 | 91 | 114 |
| Loss before income taxes | (3,671) | (2,560) | (6,105) | (2,464) |
| Income tax benefit (expense) | (12) | — | (12) | 106 |
| Net loss | $(3,683) | $(2,560) | $(6,117) | $(2,358) |
| Basic loss per share | $(0.29) | $(0.20) | $(0.48) | $(0.19) |
| Diluted loss per share | $(0.29) | $(0.20) | $(0.48) | $(0.19) |
| Shares used in per share calculations: | | | | |
| Basic | 12,697 | 12,577 | 12,685 | 12,563 |
| Diluted | 12,697 | 12,577 | 12,685 | 12,563 |
| | | | | |
| Net loss | $(3,683) | $(2,560) | $(6,117) | $(2,358) |
| Other comprehensive income | | | | |
| Foreign currency translation, net of tax | 21 | 14 | 10 | 22 |
| Unrealized gain (loss) on investments, net of tax | (8) | (2) | 2 | 3 |
| Total other comprehensive income | 13 | 12 | 12 | 25 |
| Comprehensive loss | $(3,670) | $(2,548) | $(6,105) | $(2,333) |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net loss | $(6,117) | $(2,358) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 305 | 320 |
| Stock-based compensation | 315 | 810 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 1,795 | 2,879 |
| Contract assets | (136) | 450 |
| Prepaid expenses and other assets | 70 | (331) |
| Third-party software fees payable | (928) | (5,748) |
| Accounts payable and accrued expenses | (319) | (261) |
| Deferred revenue | (1,219) | (1,378) |
| Deferred rent | (168) | (155) |
| Net cash used in operating activities | (6,402) | (5,772) |
| Cash flows from investing activities: | | |
| Purchases of equipment and furniture | (488) | (264) |
| Proceeds from maturities of short-term investments | 10,875 | 19,699 |
| Purchases of short-term investments | (6,607) | (18,641) |
| Net cash provided by investing activities | 3,780 | 794 |
| Cash flows from financing activities—proceeds from exercise of stock options | 17 | 118 |
| Effect of exchange rate changes on cash and cash equivalents | (16) | 16 |
| Net decrease in cash and cash equivalents | (2,621) | (4,844) |
| Cash and cash equivalents, beginning of period | 12,859 | 14,312 |
| Cash and cash equivalents, end of period | $10,238 | $9,468 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(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. In the Condensed Consolidated Statements of Operations and Comprehensive Loss, prior period software revenue has been separately presented as third-party software and proprietary software to conform to current period presentation. 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 June 30, 2018, our operating results for the three and six months ended June 30, 2018 and 2017 and our cash flows for the six months ended June 30, 2018. The accompanying financial information as of December 31, 2017 is derived from audited financial statements as of that date. 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, 2017, as filed with the SEC on February 22, 2018. All intercompany balances have been eliminated.

Recently Issued Accounting Standard

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, "Leases" ("ASU 2016-02"), to make leasing activities more transparent and comparable, requiring most leases to be recognized by lessees on their balance sheets as right-of-use assets, along with corresponding lease liabilities. ASU 2016-02 is effective for annual periods beginning after December 31, 2018 and interim periods within that year, with early adoption permitted. There are additional optional practical expedients that an entity may elect to apply. We plan to adopt this ASU beginning on January 1, 2019 and expect to elect certain available transitional practical expedients. We are continuing to evaluate the full impact of adoption and expect this ASU will have a material impact on our consolidated financial statements, primarily to our consolidated balance sheets 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" ("ASU 2017-04"), simplifying how an entity is required to test goodwill for impairment by eliminating step two 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.

Loss Per Share

We compute basic loss 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 and restricted stock units ("RSUs").

We consider RSUs as outstanding common shares and include them in the computation of basic loss per share only when vested. We compute diluted loss 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.

The following potentially dilutive shares were excluded from the calculation of diluted net loss per share because their effect would have been anti-dilutive for the periods presented:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Stock options | 1,478,347 | 1,406,504 | 1,502,275 | 1,413,608 |
| Restricted stock units | 60,788 | 43,382 | 61,130 | 45,947 |

2. Revenue Recognition

On January 1, 2017, we adopted ASU 2014-09, "Revenue from Contracts with Customers" ("Topic 606"), applying the modified retrospective method to all contracts that were not completed as of that date. Results for reporting periods beginning after January 1, 2017 are presented under Topic 606, while prior period results are not adjusted and continue to be reported under the accounting standards in effect for the prior period. We recorded an increase to opening equity of $404,000 as of January 1, 2017 due to the cumulative impact of adopting Topic 606.

Disaggregation of revenue

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

| | Three Months Ended June 30, 2018 | | | | Three Months Ended June 30, 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Third-Party Software | Proprietary Software | Professional Engineering Service | Total | Third-Party Software | Proprietary Software | Professional Engineering Service | Total |
| Primary geographical markets: | | | | | | | | |
| North America | $16,281 | $ 265 | $ 1,633 | $18,179 | $14,956 | $ 473 | $ 2,299 | $17,728 |
| Europe | 702 | 5 | 182 | 889 | 435 | — | 379 | 814 |
| Asia | 9 | 11 | 115 | 135 | 114 | 8 | 184 | 306 |
| Total | $16,992 | $ 281 | $ 1,930 | $19,203 | $15,505 | $ 481 | $ 2,862 | $18,848 |

| | Six Months Ended June 30, 2018 | | | | Six Months Ended June 30, 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Third-Party Software | Proprietary Software | Professional Engineering Service | Total | Third-Party Software | Proprietary Software | Professional Engineering Service | Total |
| Primary geographical markets: | | | | | | | | |
| North America | $31,400 | $ 1,948 | $ 4,120 | $37,468 | $31,252 | $ 3,118 | $ 5,128 | $39,498 |
| Europe | 1,295 | 105 | 428 | 1,828 | 859 | — | 777 | 1,636 |
| Asia | 361 | 23 | 201 | 585 | 191 | 17 | 347 | 555 |
| Total | $33,056 | $ 2,076 | $ 4,749 | $39,881 | $32,302 | $ 3,135 | $ 6,252 | $41,689 |

Contract balances

We receive payments from customers based upon contractual billing schedules; accounts receivable is 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 deferred contract acquisition costs, which are amortized over time as the associated revenue is recognized. Contract liabilities, presented as deferred revenue on our condensed consolidated balance sheets, include payments received in advance of performance under the contract and are realized when the associated revenue is recognized under the contract. We had no asset impairment charges related to contract assets for each of the three and six months ended June 30, 2018 and 2017.

Significant changes in the contract assets and the deferred revenue balances during the six months ended June 30, 2018 were as follows (in thousands):

| | Six Months Ended June 30, 2018 | |
|---|---|---|
| | Contract Assets | Deferred Revenue |
| Revenue recognized that was included in deferred revenue at December 31, 2017 | $— | $ 2,681 |
| Transferred to receivables from contract assets recognized at December 31, 2017 | 238 | — |

Contract acquisition costs

We capitalize contract acquisition costs for contracts with a term exceeding one year, as is more common with our DataV software bookings. Amortization of contract acquisition costs was $7,000 for each of the three months ended June 30, 2018 and 2017 and was $86,000 and $148,000 for the six months ended June 30, 2018 and 2017, respectively. There were no asset impairment charges for contract acquisitions costs for any of the periods noted above.

For contracts that have a duration of less than one year, we apply a practical expedient and fully expense these costs as incurred.

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 (in thousands). The estimated revenue does not include contracts with original durations of one year or less, amounts of variable consideration attributable to royalties, or contract renewals that are unexercised as of June 30, 2018:

| | Remainder of 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| Third-party software | $ 55 | $50 | $14 | $— |
| Proprietary software | 1,028 | 1,699 | 1,615 | 445 |
| Professional engineering services | 230 | — | — | — |

Practical expedients and exemptions

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

3. Cash, Cash Equivalents and Short-Term Investments

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

| | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Cash | $7,238 | $ 6,340 |
| Cash equivalents (see detail in Note 4) | 3,000 | 6,519 |
| Total cash and cash equivalents | 10,238 | 12,859 |
| Short-term investments (see detail in Note 4) | 7,623 | 11,895 |
| Total cash, cash equivalents and short-term investments | $17,861 | $ 24,754 |

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 measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017 are summarized below (in thousands):

| | June 30, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Direct or Indirect Observable Inputs (Level 2) | Total |
| Assets | | | | | | |
| Cash equivalents: | | | | | | |
| Money market funds | $1,717 | $ — | $1,717 | $2,274 | $ — | $2,274 |
| Corporate commercial paper | — | 500 | 500 | — | 3,245 | 3,245 |
| Corporate debt | — | 783 | 783 | — | 1,000 | 1,000 |
| Total cash equivalents | 1,717 | 1,283 | 3,000 | 2,274 | 4,245 | 6,519 |
| Short-term investments: | | | | | | |
| Corporate commercial paper | — | 3,729 | 3,729 | — | 5,480 | 5,480 |
| Corporate debt | — | 3,894 | 3,894 | — | 6,415 | 6,415 |
| Total short-term investments | — | 7,623 | 7,623 | — | 11,895 | 11,895 |
| Total assets measured at fair value | $1,717 | $ 8,906 | $10,623 | $2,274 | $ 16,140 | $18,414 |

As of each of June 30, 2018 and December 31, 2017, contractual maturities of our short-term investments were less than one year, and gross unrealized gains and losses on those investments were not material.

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. There were no changes in the carrying amount of goodwill during the three and six months ended June 30, 2018.

Intangible assets are related 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):

| | June 30, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Amortization | Net Book Value | Gross Carrying Amount | Amortization | Net Book Value |
| Customer relationships: | $1,275 | $ (959) | $316 | $1,275 | $ (910) | $365 |

Amortization expense was $24,000 for each of the three months ended June 30, 2018 and 2017, and $49,000 for each of the six months ended June 30, 2018 and 2017. Amortization in future periods is expected to be as follows (in thousands):

| | |
|---|---|
| Remainder of 2018 | $49 |
| 2019 | 98 |
| 2020 | 98 |
| 2021 | 71 |
| Total | $316 |

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 $12.0 million. On September 29, 2016, the Credit Agreement was modified to extend the final due date for 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. While we were in compliance with all covenants under the Credit Agreement as of June 30, 2018, the required interest coverage ratio would not permit us to borrow under the Credit Agreement.

There were no amounts outstanding under the Credit Agreement as of June 30, 2018 or December 31, 2017. In September 2016, we entered into a letter of credit agreement for $250,000, secured by the Credit Agreement in connection with the lease of our corporate headquarters. Accordingly, the maximum principal amount available, if we were eligible to borrow under the Credit Agreement, was reduced 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 (together with the Stock Plan, 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, restricted and unrestricted stock awards, and RSUs.

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 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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Dividend yield | 0 | % | 0 | % | 0 | % | 0 | % |
| Expected life | 5.2 years | | 3.3 years | | 5.3 years | | 3.3 years | |
| Expected volatility | 55 | % | 52 | % | 54 | % | 53 | % |
| Risk-free interest rate | 2.7 | % | 1.6 | % | 2.5 | % | 1.7 | % |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Cost of revenue — professional engineering service | $8 | $20 | $19 | $85 |
| Selling, general and administrative | (80) | 320 | 184 | 604 |
| Research and development | 56 | 71 | 112 | 121 |
| Total stock-based compensation expense | $(16) | $411 | $315 | $810 |
| Per diluted share | $(0.00) | $0.03 | $0.02 | $0.06 |

Stock Option Activity

The following table summarizes stock option activity under the Plans:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Balance at December 31, 2017 | 1,912,161 | $ 4.88 | 7.61 | $781,735 |
| Granted | 256,643 | 3.95 | | |
| Exercised | (2,422) | 3.59 | | |
| Forfeited | (265,697) | 4.90 | | |
| Expired | (22,605) | 5.72 | | |
| Balance at June 30, 2018 | 1,878,080 | $ 4.74 | 6.28 | $5,080 |
| Vested and expected to vest at June 30, 2018 | 1,784,268 | $ 4.73 | 6.14 | $5,080 |
| Exercisable at June 30, 2018 | 1,181,163 | $ 4.60 | 4.80 | $5,080 |

At June 30, 2018, total compensation cost related to stock options granted but not yet recognized was $745,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.4 years. The following table summarizes certain information about stock options:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Weighted average grant-date fair value of options granted during the period | $1.77 | $2.64 | $1.98 | $2.80 |
| Options in-the-money (in shares) | 19,550 | 1,755,762 | 19,550 | 1,755,762 |
| Aggregate intrinsic value of options exercised during the period | $1,578 | $17,412 | $1,853 | $57,833 |

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 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 under the Plans:

| | Number of Shares | Weighted Average Award Price |
|---|---|---|
| Unvested at December 31, 2017 | 116,968 | $ 5.33 |
| Granted | 136,505 | 3.21 |
| Vested | (46,764 ) | 5.14 |
| Forfeited | (26,312 ) | 5.31 |
| Unvested at June 30, 2018 | 180,397 | $ 3.78 |
| Expected to vest after June 30, 2018 | 165,730 | $ 3.75 |

At June 30, 2018, total compensation cost related to RSUs granted but not yet recognized was $433,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 0.8 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 June 30, 2018:

| | June 30, 2018 |
|---|---|
| Stock options outstanding | 1,878,080 |
| Restricted stock units outstanding | 180,397 |
| Stock options available for future grant | 1,110,722 |
| Common stock reserved for future issuance | 3,169,199 |

8. Commitments and Contingencies

Lease and rent obligations

Our commitments include obligations outstanding under operating leases, which expire through 2021. We have lease commitments for office space in Bellevue, Washington; Boston, Massachusetts; Taipei, Taiwan; 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 $220,000 and $273,000 for the three months ended June 30, 2018 and 2017, respectively, and $484,000 and $533,000 for the six months ended June 30, 2018 and 2017, respectively.

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

| | June 30, 2018 |
|---|---|
| Remainder of 2018 | $ 581 |
| 2019 | 1,128 |
| 2020 | 527 |
| 2021 | 15 |
| Total commitments | $ 2,251 |

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 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 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 three major product lines – third-party software, proprietary software and professional engineering service – each of which we consider to be operating and reportable segments. We do not allocate costs other than direct cost of goods sold to the segments or produce segment income statements, and we do not produce asset information by reportable segment. The following table sets forth profit and loss information about our segments (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Third-party software: | | | | |
| Revenue | $16,992 | $15,505 | $33,056 | $32,302 |
| Cost of revenue | 14,480 | 13,103 | 27,834 | 27,185 |
| Gross profit | 2,512 | 2,402 | 5,222 | 5,117 |
| Proprietary software: | | | | |
| Revenue | 281 | 481 | 2,076 | 3,135 |
| Cost of revenue | 100 | 39 | 141 | 71 |
| Gross profit | 181 | 442 | 1,935 | 3,064 |
| Professional Engineering Service: | | | | |
| Revenue | 1,930 | 2,862 | 4,749 | 6,252 |
| Cost of revenue | 1,362 | 1,833 | 3,445 | 4,307 |
| Gross profit | 568 | 1,029 | 1,304 | 1,945 |
| Total gross profit | 3,261 | 3,873 | 8,461 | 10,126 |
| Operating expenses | 6,979 | 6,492 | 14,657 | 12,704 |
| Other income, net | 47 | 59 | 91 | 114 |
| Income tax benefit (expense) | (12) | — | (12) | 106 |
| Net loss | $(3,683) | $(2,560) | $(6,117) | $(2,358) |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Total revenue: | | | | |
| North America | $18,179 | $17,728 | $37,468 | $39,498 |
| Asia | 135 | 306 | 585 | 555 |
| Europe | 889 | 814 | 1,828 | 1,636 |
| Total revenue | $19,203 | $18,848 | $39,881 | $41,689 |

| | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Long-lived assets: | | |
| North America | $1,285 | $ 991 |
| Asia | 113 | 76 |
| Europe | 4,081 | 4,114 |
| Total long-lived assets | $5,479 | $ 5,181 |

10. Significant Risk Concentrations

Significant Customer

Honeywell International, Inc. and affiliated entities (“Honeywell”) accounted for $4.1 million, or 10% of total revenue, for the six months ended June 30, 2018. No customers accounted for 10% or more of total revenue for the three months ended June 30, 2018. Honeywell accounted for $3.0 million, or 16% of total revenue, for the three months ended June 30, 2017 and $6.3 million, or 15% of total revenue for the six months ended June 30, 2017. No other customers accounted for 10% or more of total revenue for the periods noted above.

Honeywell had accounts receivable balances of $7.6 million, or approximately 47% of total accounts receivable, at June 30, 2018, and $8.7 million, or approximately 48% of total accounts receivable, at December 31, 2017. No other customer accounted for 10% or more of the total accounts receivable at June 30, 2018 or December 31, 2017.

Significant Supplier

We have 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 have been extended through February 28, 2019. We also have 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 expire on April 30, 2022.

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 and the remaining 70% to offset qualified marketing expenses in the period the expenditures are incurred.

Under this rebate program, we recorded rebate credits as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Reductions to cost of revenue | $158 | $87 | $418 | $197 |
| Reductions to marketing expense | $113 | $219 | $379 | $374 |

There was a balance of approximately $369,000 in qualified outstanding rebate credits at June 30, 2018, which will be accounted for as a reduction in marketing expense in the period in which qualified program expenditures are made.

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, 2017 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

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 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 early 2014, we initiated development efforts focused on new proprietary software products addressing the Industrial Internet of Things ("IIoT") market, by interconnecting of uniquely identifiable devices, extracting data from those devices and applying advanced analytics and machine learning to the data in order to derive meaningful and actionable insights. While IIoT is a relatively new market, we believe the work we have engaged in since our inception—namely adding intelligence and connectivity to discrete standalone devices and systems—embodies much of what is central to the core functionality of IIoT. These software development efforts have driven a new business initiative for BSQUARE, which we refer to as DataV™. Our DataV solution includes software products, applications and services that are designed to turn raw IIoT device data into meaningful and actionable data for our customers.

We launched DataV late in the first quarter of 2016 and announced our first three major customer bookings later that year. These bookings are comprised of software licensing, software maintenance and related systems integration services and are, we believe, indicative of the potential customer demand for DataV. During the first half of 2018, we entered into a multi-year DataV Software-as-a-Service (“SaaS”) contract with an engineering service contract with a Fortune 100 firm to deliver IIoT device and content management to IIoT devices across North America and Europe.

We believe that DataV presents significant opportunities in an expanding and evolving market, at substantially higher gross margins as compared to our traditional business. Developing, selling and implementing DataV has become our primary focus, representing a transition away from dependence on resale software and professional engineering services toward increased reliance on our own proprietary software and related systems integration services. We intend to continue to run our legacy software resale business to maximize cash flow for the foreseeable future. Our legacy professional engineering services business is now managed as a part of our overall services business, which increasingly serves DataV customers and prospects.

Critical Accounting Judgments

Management's discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales, cost of sales and expenses and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There have been no significant changes to our critical accounting judgments, policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2017.

Results of Operations

The following table presents our summarized results of operations for the periods indicated. Our historical operating results are not necessarily indicative of the results for any future period.

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| (In thousands, except percentages) | 2018 | 2017 | $ Change | % Change | 2018 | 2017 | $ Change | % Change |
| Revenue | $19,203 | $18,848 | $355 | 2 % | $39,881 | $41,689 | $(1,808) | (4 )% |
| Cost of revenue | 15,942 | 14,975 | 967 | 6 % | 31,420 | 31,563 | (143) | (— )% |
| Gross profit | 3,261 | 3,873 | (612) | (16 )% | 8,461 | 10,126 | (1,665) | (16 )% |
| Operating expenses | 6,979 | 6,492 | 487 | 8 % | 14,657 | 12,704 | 1,953 | 15 % |
| Loss from operations | (3,718) | (2,619) | (1,099) | 42 % | (6,196) | (2,578) | (3,618) | 140 % |
| Other income, net | 47 | 59 | (12) | (20 )% | 91 | 114 | (23) | (20 )% |
| Loss before income taxes | (3,671) | (2,560) | (1,111) | 43 % | (6,105) | (2,464) | (3,641) | 148 % |
| Income tax benefit (expense) | (12) | — | (12) | n.m. | (12) | 106 | (118) | (111 )% |
| Net loss | $(3,683) | $(2,560) | $(1,123) | 44 % | $(6,117) | $(2,358) | $(3,759) | 159 % |

Revenue

We generate revenue from the sale of software, both third-party software that we resell and our own proprietary software, and the sale of professional engineering services. Total revenue increased for the quarterly period ended June 30, 2018 compared to the prior year period, primarily due to higher sales of Microsoft Windows Embedded operating systems. This increase was partially offset by lower professional engineering service revenue, predominantly in North America.

Total revenue decreased for the year-to-date period ended June 30, 2018 due to lower sales of Microsoft Windows Mobile operating systems, as well as lower professional engineering service and proprietary software revenue. These decreases were partially offset by higher sales of Microsoft Windows Embedded operating systems.

Additional revenue details are as follows:

| | Three Months Ended June 30, | Six Months Ended June 30, |
|---|---|---|

| (In thousands, except percentages) | 2018 | 2017 | $ Change | % Change | 2018 | 2017 | $ Change | % Change |
|---|---|---|---|---|---|---|---|---|
| Revenue | | | | | | | | |
| Third-party software | $16,992 | $15,505 | $1,487 | 10 % | $33,056 | $32,302 | $754 | 2 % |
| Proprietary software | 281 | 481 | (200) | (42)% | 2,076 | 3,135 | (1,059) | (34)% |
| Professional engineering service | 1,930 | 2,862 | (932) | (33)% | 4,749 | 6,252 | (1,503) | (24)% |
| Total revenue | $19,203 | $18,848 | $355 | | $39,881 | $41,689 | $(1,808) | |
| As a percentage of total revenue: | | | | | | | | |
| Third-party software | 89 % | 82 % | | | 83 % | 77 % | | |
| Proprietary software | 1 % | 3 % | | | 5 % | 8 % | | |
| Professional engineering service | 10 % | 15 % | | | 12 % | 15 % | | |

Third-party software revenue

Third-party software revenue increased for the quarterly period ended June 30, 2018, primarily due to higher sales of Microsoft Windows Embedded operating systems as the result of timing of buying activities of our large customers, partially offset by lower sales to Honeywell. The third-party software revenue increased for the year-to-date period ended June 30, 2018 primarily due to the higher sales of Microsoft Windows Embedded operating systems, partially offset by lower sales of Microsoft Windows Mobile operating systems and lower sales to Honeywell. During the first quarter of 2018, we decided not to compete for sales in intense price competitive situations in an effort to maintain a certain gross margin level and therefore decided not to pursue sales opportunities with Honeywell in Europe. As a result, we anticipate that sales to Honeywell will decrease between $1.2 million to $1.5 million in revenue per quarter for the remainder of 2018.

Sales of Microsoft operating systems represented approximately 86% and 80% of our total revenue and 73% and 56% of our total gross margin for the three and six months ended June 30, 2018, respectively; and approximately 81% and 76% of our total revenue and 59% and 47% of our total gross margin for the three and six months ended June 30, 2017, respectively.

Proprietary software revenue

Proprietary software revenue decreased for the quarterly period ended June 30, 2018, primarily due to lower sales of other proprietary software in the current quarterly period compared to the prior year period. Proprietary software revenue decreased for the year-to-date period ended June 30, 2018, primarily due to timing of DataV software revenue recognition. Specifically, a greater portion of DataV software license fees from PACCAR was recognized in the prior year period compared to DataV software license fees from Itron that were recognized in the current year period. We expect revenue from both DataV and our other proprietary software will continue to fluctuate in timing and amount in future periods. We anticipate that our DataV revenue will grow over time, but that sales of other proprietary software products will decline over time as they approach the end of their life cycles.

Professional engineering service revenue

Professional engineering service revenue decreased for the quarterly and year-to-date periods ended June 30, 2018, largely due to a decrease in service revenue in North America with the completion in 2017 of several existing customer projects. We expect that professional engineering service revenue will vary in timing and amount in future periods as we continue to align our organizational structure with our increasing strategic focus on DataV.

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 and gross margin were as follows:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| (In thousands, except percentages) | 2018 | 2017 | $ Change | % Change | 2018 | 2017 | $ Change | % Change |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Third-party software gross profit | $2,512 | | $2,402 | | $ 110 | 5 | % | $5,222 | | $5,117 | | $105 | 2 | % |
| Third-party software gross margin | 15 | % | 15 | % | | (— | )% | 16 | % | 16 | % | | (— | )% |
| Proprietary software gross profit | 181 | | 442 | | (261 | ) (59 | )% | 1,935 | | 3,064 | | (1,129 | ) (37 | )% |
| Proprietary software gross margin | 64 | % | 92 | % | | (28 | )% | 93 | % | 98 | % | | (5 | )% |
| Professional engineering service gross profit | 568 | | 1,029 | | (461 | ) (45 | )% | 1,304 | | 1,945 | | (641 | ) (33 | )% |
| Professional engineering service gross margin | 29 | % | 36 | % | | (7 | )% | 27 | % | 31 | % | | (4 | )% |
| Total gross profit | $3,261 | | $3,873 | | $ (612 | ) (16 | )% | $8,461 | | $10,126 | | $(1,665 | ) (16 | )% |
| Total gross margin | 17 | % | 21 | % | | (4 | )% | 21 | % | 24 | % | | (3 | )% |

Third-party software gross profit and gross margin

Third-party software gross profit increased for each of the quarterly and year-to-date periods ended June 30, 2018 due to higher sales of third-party software. Third-party software gross margin remained relatively constant for the quarterly and year-to-date periods ended June 30, 2018.

Gross profit on third-party software is positively impacted by rebate credits that we receive from Microsoft for the sale of Windows Embedded operating systems earned through the achievement of defined objectives. Under the Microsoft rebate program, we recognized $158,000 and $418,000 of rebate credits during the three and six months ended June 30, 2018, respectively, compared to $87,000 and $197,000 during the three and six months ended June 30, 2017, respectively, all of which were accounted for as reductions in cost of revenue.

Proprietary software gross profit and gross margin

Proprietary software gross profit decreased for the quarterly period ended June 30, 2018 primarily due to lower sales of other proprietary software. Proprietary software gross profit decreased for the year-to-date period ended June 30, 2018, primarily due to the timing of DataV software revenue recognition.

Proprietary software gross margin decreases for each of the quarterly and year-to-date periods ended June 30, 2018 were largely due to higher cost of sales related to maintenance and support activities for DataV.

Professional engineering service gross profit and gross margin

Professional engineering service gross profit decreased for each of the quarterly and year-to-date periods ended June 30, 2018 primarily due to lower professional engineering service revenue.

Professional engineering service gross margin decreased for each of the quarterly and year-to-date periods ended June 30, 2018 primarily due to a higher utilization of engineering services in the prior year periods.

Operating expenses

The following table presents our operating expenses for the periods indicated:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| (In thousands, except percentages) | 2018 | 2017 | $ Change | % Change | 2018 | 2017 | $ Change | % Change |
| Operating expenses: | | | | | | | | |
| Selling, general and administrative | $4,901 | $5,046 | $ (145) | (3)% | $10,349 | $9,911 | $ 438 | 4 % |
| Research and development | 2,078 | 1,446 | 632 | 44 % | 4,308 | 2,793 | 1,515 | 54 % |
| Total operating expenses | $6,979 | $6,492 | $ 487 | 8 % | 14,657 | 12,704 | 1,953 | 15 % |
| As a percentage of total revenue: | | | | | | | | |
| Selling, general and administrative | 26 % | 27 % | | | 26 % | 24 % | | |
| Research and development | 11 % | 8 % | | | 11 % | 7 % | | |

Selling, general and administrative

Selling, general and administrative (“SG&A”) 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 decreased for the quarterly period ended June 30, 2018, primarily due to lower stock compensation expense resulting from the departures of certain management team members and lower recruiting fees. These decreases were partially offset by higher severance costs

from those departures and spending reduction efforts made in the second quarter of fiscal 2018.

SG&A expenses increased for the year-to-date period ended June 30, 2018 primarily due to higher salaries and related benefits resulting from the strengthening of our sales team that occurred throughout 2017 as well as higher severance costs. This increase for the year-to-date period was partially offset by lower stock compensation expense and lower recruiting fees.

Research and development

Research and development ("R&D") expenses consist primarily of salaries and related benefits for software development and quality assurance personnel, contractor and consultant costs, and related facilities and depreciation costs. R&D expenses increased for each of the quarterly and year-to-date periods ended June 30, 2018, due to increased spending for continued development of our DataV product line.

Other income, net

Other income, net consists primarily of interest income on our cash and investments, gains and losses we may recognize on our investments, and gains and losses on foreign exchange transactions and other items. We had an immaterial change in other income, net for each of the quarterly and year-to-date periods ended June 30, 2018.

Income taxes

Income taxes increased for the year-to-date period ended June 30, 2018, primarily due to the tax benefit recorded in the prior year period which was not repeated in the current period. The tax benefit in the prior year period was related to non-recurring discrete items, including U.K. stock compensation tax benefits, a U.K. net operating loss carryback and an international tax reserve release.

Liquidity and Capital Resources

As of June 30, 2018, we had $17.9 million of cash, cash equivalents and investments, compared to $24.8 million at December 31, 2017, reflecting a net use of approximately $6.9 million in cash, cash equivalents and investments during the six months ended June 30, 2018. We generally invest our excess cash in high quality marketable investments. These investments generally include corporate notes and bonds, commercial paper and money market funds, although specific holdings can vary from period to period depending upon our cash requirements. Our investments held at June 30, 2018 had minimal default risk and short-term maturities.

Cash Flows from Operating Activities

Operating activities used cash of approximately $6.4 million for the six months ended June 30, 2018, which included a working capital usage of approximately $0.9 million and our net loss (offset by non-cash adjustments) of $5.5 million. The working capital usage included cash outflows of $1.2 million related to deferred revenue, primarily on DataV contracts, and $0.9 million related to third-party software fees payable, partially offset by $1.8 million of cash inflows related to accounts receivable, primarily from lower sales to Honeywell in Europe.

Operating activities used cash of approximately $5.8 million for the six months ended June 30, 2017, which included a working capital usage of approximately $4.6 million and our net loss (offset by non-cash adjustments) of $1.2 million. The working capital usage included cash outflows of $5.7 million related to third-party software fees payable, partially offset by $2.9 million of cash inflows related to accounts receivable.

Cash Flows from Investing Activities

Investing activities provided cash of approximately $3.8 million for the six months ended June 30, 2018, due to net cash inflows on short-term investments of $4.3 million, partially offset by $0.5 million in purchases of equipment and furniture, primarily related to capitalized software development costs.

Investing activities provided cash of approximately $0.8 million for the six months ended June 30, 2017, primarily due to net cash inflows on short-term investments of $1.1 million.

Cash Flows from Financing Activities

Financing activities provided cash of approximately $17,000 and $118,000 during the six months ended June 30, 2018 and 2017, respectively, generated from 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.

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 $12.0 million. On September 29, 2016, the Credit Agreement was modified to extend the final due date for an additional year to September 22, 2018 (the “Expiration Date”). We do not plan to renew the Credit Agreement with the Bank beyond the Expiration Date. There were no amounts outstanding under the Credit Agreement as of June 30, 2018 or December 31, 2017. In September

2016, we entered into a letter of credit agreement for $250,000 secured by the Credit Agreement in connection with the lease of our corporate headquarters. Accordingly, the maximum principal amount available, if we were eligible to borrow under the Credit Agreement, was reduced to $11.75 million. While we were in compliance with all covenants under the Credit Agreement as of June 30, 2018, the required interest coverage ratio would not permit us to borrow under the Credit Agreement. 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 $0.6 million for the remainder of 2018, $1.1 million in 2019, $0.5 million in 2020 and thereafter.

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 controls over financial reporting during the three months ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal controls 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, 2017.

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit Number | Description | Filed or Furnished Herewith | Incorporated by Reference | | | |
|---|---|---|---|---|---|---|
| | | | Form | Filing Date | Exhibit | File No. |
| 3.1 | Amended and Restated Articles of Incorporation | | S-1 | August 17, 1999 | 3.1 (a) | 333-85351 |
| 3.1(a) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 10-Q | August 7, 2000 | 3.1 | 000-27687 |
| 3.1(b) | Articles of Amendment to Amended and Restated Articles of Incorporation | | 8-K | October 11, 2005 | 3.1 | 000-27687 |
| 3.2 | Bylaws and all amendments thereto | | 10-K | March 19, 2003 | 3.2 | 000-27687 |
| 10.1[(1)] | Separation and Release Agreement with Jerry D. Chase effective May 9, 2018 | X | | | | |
| 10.2[(1)] | Employment letter agreement with Kevin T. Walsh dated June 26, 2015 | X | | | | |
| 10.3[(1)] | Employment letter agreement with Giles Frith dated August 31, 2016 | X | | | | |
| 10.4[(1)] | Amendment to employment letter agreement with Giles Frith dated June 5, 2018 | X | | | | |
| 10.5[(1)] | Employment letter agreement with David Wagstaff dated August 31, 2016 | X | | | | |
| 10.6[(1)] | Amendment to employment letter agreement with David Wagstaff dated June 5, 2018 | X | | | | |
| 31.1 | Certification of Acting 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 Acting Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | | |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | | |
| 101.INS | XBRL Instance Document | X | | | | |
| 101.SCH | XBRL Taxonomy Extension Schema | X | | | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase | X | | | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase | X | | | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase | X | | | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase | X | | | | |

[(1)] Indicates a management contract or compensatory plan or arrangement.

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SIGNATURES

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

BSQUARE CORPORATION

(Registrant)

Date: August 13, 2018 By: /s/ Peter J. Biere
Peter J. Biere
Chief Financial Officer, Assistant Secretary and Treasurer