LUNA INNOVATIONS INC
Form 10-Q
May 11, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2017
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware	54-1560050
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

301 First Street SW, Suite 200
Roanoke, VA 24011
(Address of Principal Executive Offices)
(540) 769-8400
(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. ý 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). ý 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 o Accelerated filer o

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

Emerging growth company o

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. o

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of May 9, 2017, there were 27,989,104 shares of the registrant's common stock outstanding.

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FOR THE QUARTER ENDED MARCH 31, 2017
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
Luna Innovations Incorporated
Consolidated Balance Sheets

	March 31, 2017 (unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$12,105,934	$12,802,458
Accounts receivable, net	12,256,152	14,297,725
Inventory	8,722,670	8,370,235
Prepaid expenses and other current assets	1,536,003	1,627,175
Total current assets	34,620,759	37,097,593
Property and equipment, net	6,575,200	6,780,838
Intangible assets, net	8,280,903	8,681,263
Goodwill	2,348,331	2,348,331
Other assets	68,778	88,948
Total assets	$51,893,971	$54,996,973
Liabilities and stockholders’ equity		
Liabilities:		
Current liabilities:		
Current portion of long-term debt obligations	$1,833,333	$1,833,333
Current portion of capital lease obligations	53,043	52,128
Accounts payable	3,147,754	4,466,192
Accrued liabilities	8,672,431	8,667,100
Deferred revenue	843,345	949,603
Total current liabilities	14,549,906	15,968,356
Long-term deferred rent	1,372,356	1,403,957
Long-term debt obligations	1,965,776	2,420,032
Long-term capital lease obligations	101,328	114,940
Total liabilities	17,989,366	19,907,285
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock, par value $0.001, 1,321,514 shares authorized, issued and outstanding at March 31, 2017 and December 31, 2016	1,322	1,322
Common stock, par value $0.001, 100,000,000 shares authorized, 27,989,104 and 27,988,104 shares issued, 27,542,277 and 27,541,277 shares outstanding at March 31, 2017 and December 31, 2016	28,621	28,600
Treasury stock at cost, 446,827 shares at March 31, 2017 and December 31, 2016	(517,987)	(517,987)
Additional paid-in capital	82,656,937	82,451,958
Accumulated deficit	(48,264,288)	(46,874,205)
Total stockholders’ equity	33,904,605	35,089,688
Total liabilities and stockholders’ equity	$51,893,971	$54,996,973

The accompanying notes are an integral part of these consolidated financial statements.

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Luna Innovations Incorporated
Consolidated Statements of Operations

	Three Months Ended March 31, 2017	2016
	(unaudited)	
Revenues:		
Technology development	$4,276,448	$3,723,262
Products and licensing	8,841,936	10,263,753
Total revenues	13,118,384	13,987,015
Cost of revenues:		
Technology development	3,222,354	2,846,723
Products and licensing	5,220,775	6,296,685
Total cost of revenues	8,443,129	9,143,408
Gross profit	4,675,255	4,843,607
Operating expense:		
Selling, general and administrative	4,495,701	4,645,282
Research, development and engineering	1,444,828	1,550,491
Total operating expense	5,940,529	6,195,773
Operating loss	(1,265,274)	(1,352,166)
Other income/(expense):		
Other income, net	351	3,940
Interest expense	(64,374)	(86,173)
Total other expense	(64,023)	(82,233)
Loss before income taxes	(1,329,297)	(1,434,399)
Income tax expense	26,690	25,175
Net loss	(1,355,987)	(1,459,574)
Preferred stock dividend	34,096	21,210
Net loss attributable to common stockholders	$(1,390,083)	$(1,480,784)
Net loss per share attributable to common stockholders:		
Basic and diluted	$(0.05)	$(0.05)
Weighted average common shares and common equivalent shares outstanding:		
Basic and diluted	27,541,356	27,477,181

The accompanying notes are an integral part of these consolidated financial statements.

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Luna Innovations Incorporated
Consolidated Statements of Cash Flows

	Three Months Ended March 31, 2017 (unaudited)	2016						
Cash flows provided by/(used in) operating activities								
Net loss	$(1,355,987)	$(1,459,574	$	$	$	$	$ 3,000	$ 211,000

Mark E. McMillan(5) *Vice President, Worldwide Sales and Marketing*	2010	$	132,308	$	$ 78,180	$ 74,977	$ 100,069	$	3,719	$ 389,253

(1) The amounts in this column reflect the aggregate grant-date fair value of restricted stock units granted under our Annual Executive Bonus Program (AEBP), determined in accordance with FASB Accounting Standards Codification Topic 718 for stock-based compensation. The amounts included for a particular year reflect only the awards treated as granted in that year. Pursuant to SEC rules, the amounts shown disregard the impact of estimated forfeitures related to service-based vesting conditions. Assumptions used in the calculation of these award amounts are set forth in Note 7 (Shareholders Equity) to the financial statements included in our 2010 Form 10-K.

(2) The amounts in this column reflect the aggregate grant-date fair value of option awards, determined in accordance with FASB Accounting Standards Codification Topic 718 for stock-based compensation. The amounts included for a particular year reflect only the awards treated as granted in that year. Pursuant to SEC rules, the amounts shown disregard the impact of estimated forfeitures related to service-based vesting conditions. Assumptions used in the calculation of these award amounts set forth in Note 7 (Shareholders Equity) to the financial statements included in our 2010 Form 10-K.

(3) The amounts in this column with respect to Mr. Crowley and Mr. Mahan represent cash awards earned for the indicated year, as applicable under the AEBP. The amount in this column with respect to Mr. McMillan represents cash awards earned by him as described below under Incentive Plan Compensation Incentive Sales Compensation Plan.

(4) Represents 401(k) matching employer contributions, premiums paid by the Company under a group life insurance plan, and an allowance for mobile telephone and data service, which includes personal use. In previous years, we have included the amount of the telephone and data service allowance paid to each of our named executive officers in Salary. This allowance, which is currently $1,800 per year, is now being included in All Other Compensation for both years shown in the table.

(5) Mr. McMillan joined the Company in February 2010.

Employment Agreements with Named Executive Officers

We have agreements with our named executive officers, which include provisions regarding post-termination compensation. We do not have a formal severance policy or plan applicable to our executive officers as a group. Under the agreements with Mr. Crowley and Mr. Mahan, if either officer is terminated without cause (as defined in the applicable agreement, subject to certain exceptions), they will receive termination payments equal to six months of their annual base salary, paid on our normal payroll schedule. In addition, the equity awards held by Mr. Crowley and Mr. Mahan would continue to vest post-termination over the period during which they receive these termination payments. Mr. Crowley and Mr. Mahan are entitled to these termination payments provided they enter into a separation and release agreement acceptable to the Company which includes, among other things, non-solicitation and non-competition provisions that apply for a period of twelve months following termination and an obligation to protect the property of the Company, including intellectual property.

Mr. McMillan joined our Company as Vice President of Worldwide Sales and Marketing in February 2010. Under the employment agreement with Mr. McMillan, if he is terminated when neither cause nor long-term disability exists (as defined in the agreement, subject to certain exceptions) and provided that he enters into a release of any employment-related claims acceptable to the Company, he will receive termination payments equal to four months of his annual base salary, paid on our normal payroll schedule. However, if we give Mr. McMillan at least one full month s advance notice of termination, these termination payments will be reduced by one month s salary for each full month of advance notice given. In addition, the equity awards held by Mr. McMillan would continue to vest post-termination for 120 days from the termination date.

No other benefits accrue to the named executive officers under their severance arrangements (such as continuation of medical benefits) under their current employment contracts. The incentive compensation plan applicable to Mr. McMillan for 2010 (as described below under Incentive Plan Compensation Incentive Sales Compensation Plan, and which is subject to change on a quarterly basis), provide that with respect to monthly sales commissions, he will receive payment for invoices generated prior to termination, and with respect to quarterly bonuses based on sales quotas, he must be employed on the last day of a quarter to be eligible for bonus amounts with respect to that quarter.

The agreements with our named executive officers govern the termination of the officer by the Company; they do not address termination by an acquiring company of a named executive officer after a change in control of the Company. There are no individual change-in-control agreements in effect with any of our named executive officers. The terms of our Third Amended and Restated Stock Plan (the Stock Plan) do not specifically provide for accelerated vesting of equity awards for participants in the event of a change in control. Instead, the Stock Plan provides that individual equity award agreements may provide for accelerated vesting in connection with certain transactions defined in the Stock Plan (including certain change-in-control transactions). No currently outstanding equity award agreement provides for such acceleration of vesting. In addition, the Stock Plan provides that the Board of Directors may elect to accelerate vesting for any Stock Plan participant at such times and in such amounts as the Board of Directors determines. Any change in control agreement with an executive officer, should it be deemed necessary, would require approval by the Compensation Committee and the Board of Directors.

Determination of Compensation

Total Compensation

For purposes of evaluating executive officer total compensation including base salary, discretionary bonus, equity awards and incentive compensation, the Compensation Committee primarily considers two factors:

Benchmark data: Historically, the Compensation Committee has engaged a compensation consultant on an annual basis to compare our executive compensation program with those of public companies in the Pacific Northwest with revenue of less than $100 million. A consultant was not engaged by the Compensation Committee with respect to the determination of 2009 or 2010 compensation for the reasons noted below.

Company and individual-specific factors: In addition to considering compensation levels of executives at similarly sized regional public companies, the Compensation Committee, in conjunction with the Chief Executive Officer, reviews the Company s financial performance objectives as well as non-financial performance objectives applicable to each executive (other than the Chief Executive Officer). The Company s financial performance objectives are determined through collaboration with the Chief Executive Officer, the Board of Directors and the Compensation Committee. The non-financial performance objectives applicable to each executive officer (other than the Chief Executive Officer) are determined in collaboration with the Chief Executive Officer, the executive officer and the Compensation Committee. The Compensation Committee, without input from the Chief Executive Officer, determines the financial and non-financial performance objectives applicable to the

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Chief Executive Officer. These objectives and associated awards are governed by the AEBP with respect to Mr. Crowley, Mr. Mahan, and other executive officers who are not members of the sales team, and are governed by a non-equity incentive sales compensation plan with respect to Mr. McMillan. These incentive plans are described below under Incentive Plan Compensation.

Base Salary and Discretionary Bonus

The Compensation Committee s goal is to provide a competitive base salary for our executive officers. The Compensation Committee has not established any formal guidelines for purposes of setting base salaries (such as payment at a particular percentile of the benchmark group), but instead considers the benchmark data along with the Company s performance and the individual s performance and experience in determining what represents a competitive salary. The Compensation Committee also considers these factors in its recommendations to the Board of Directors regarding whether and in what amounts to award discretionary cash bonuses, apart from cash awards that may be provided for under incentive plans.

With respect to both 2009 and 2010, in response to overall economic conditions and a need for the Company to proactively manage expenses, our Chief Executive Officer, in conjunction with the Compensation Committee and the Board of Directors, determined that executive salaries would not be changed. The Compensation Committee and the Board of Directors also determined that the Chief Executive Officer s salary would not be changed with respect to 2009 or 2010 for the same reasons. The annual base salaries set forth below with respect to Mr. Crowley and Mr. Mahan have therefore been in effect since March 2008. Mr. McMillan joined the Company in February 2010.

The following table presents the current annual base salaries of our named executive officers:

Name	**Annual Base Salary**
Brian T. Crowley	$ 270,000
Scott C. Mahan	$ 208,000
Mark E. McMillan	$ 160,000

Equity Awards

Longer-term incentives in the form of grants of stock options, restricted stock, restricted stock units and other forms of equity instruments to executive officers are governed by the Stock Plan and are made both under incentive plans and outside of those plans.

The Compensation Committee recommends grants and awards of stock options and other forms of equity instruments given to our executive officers under the Stock Plan. Grants and awards recommended by the Compensation Committee are then submitted to the Board of Directors for approval. Stock options have historically been granted at the time of hire of an executive officer. Further, the Compensation Committee periodically reviews the equity ownership of the executive officers and may recommend to the Board of Directors additional awards of equity instruments under the Stock Plan based on a number of factors, including benchmark data, Company performance and individual performance, the vested status of currently outstanding equity awards, the executive s equity ownership in relation to the other executives and other factors. The Compensation Committee maintains no formal guidelines for these periodic reviews. Stock options are awarded with exercise prices equal to the closing market price per share of our common stock on the grant date.

On February 22, 2010, in connection with his engagement as our Vice President, Worldwide Sales and Marketing, we granted to Mr. McMillan a stock option to purchase up to 50,000 shares of our common stock at an exercise price of $2.34 per share, which option vests quarterly in equal annual installments over a four-year period.

Our named executive officers also participate in incentive compensation programs. Mr. Crowley and Mr. Mahan, as well as other executive officers of the Company who are not members of the sales team, participate in the Annual Executive Bonus Program, while Mr. McMillan, as our Vice President, Worldwide Sales and Marketing, participates in a non-equity incentive sales compensation plan.

Incentive Plan Compensation

Annual Executive Bonus Program

The objectives of the AEBP are to:

- Encourage and reward individual and corporate performance;
- Seek alignment of executive officers compensation with shareholder interests on both a short-term and long-term basis; and
- Attract and retain highly-qualified executives.

The AEBP, under which executive officers have the potential to earn awards of cash and restricted stock units, is maintained in collaboration among the Compensation Committee, the Board of Directors and the Chief Executive Officer. Payment under the AEBP is contingent on the achievement of an adjusted annual net income target for the Company and the achievement of individual objectives set for the executive. Individual objectives may be related to achievements such as growing revenue streams, developing successful new products, maintaining low involuntary employee turnover and improving infrastructure to enhance business velocity.

The amount of bonus earned under the AEBP is determined by the following formula, the elements of which are described below:

Bonus Amount = *Base Salary * Target Bonus Opportunity * Company Achievement Multiplier (50% to 150%) * Individual Achievement Multipliers (0% to 100%)*

<u>Target Bonus Opportunity</u>. The Target Bonus Opportunity for each executive officer is set as a percentage of base salary. The philosophy used by the Compensation Committee in setting the Target Bonus Opportunity is similar to that used in setting base salaries for the executive officers, including consideration of the benchmark data described previously, among other things.

The 2010 Target Bonus Opportunity percentages were as follows:

Title	**Target Bonus Opportunity**
Chief Executive Officer	65%
Chief Financial Officer	45%
Vice President	35%

<u>Company Achievement Multiplier</u>. The Compensation Committee, in conjunction with the Chief Executive Officer and Board of Directors, determines the threshold financial measures that the Company must meet in order for executives to earn bonuses under the AEBP. Because reported net income contains equity-based compensation expense, and because the actual amount of compensation expense is variable based on factors largely out of the control of the executive team, the Compensation Committee has decided that net income with equity-based expense added back, or adjusted net income, will be used as the primary measure for achievement in the AEBP. Additionally, because it is not possible to accurately forecast the amount of executive bonuses earned at the start of the year, and because executive bonuses are not included in the Company s annual budget, adjusted net income excludes any executive bonus expense. The Compensation Committee also has discretion to make other adjustments based on particular facts and circumstances that may arise. The Compensation Committee has set three adjusted net income targets:

Bonus Trigger: This is the amount of adjusted net income that the Company must earn in order for any AEBP bonuses to be paid. Once adjusted net income reaches this amount, the Company Achievement Multiplier is set at 50%.

Bonus Target: This is the target adjusted net income level at which the Company Achievement Multiplier is set at 100%. This number corresponds to the net income number set forth in the 2010 budget that is formally approved by the Board of Directors, with any 2010 equity-based compensation expense estimate added back.

Bonus Cap: This is the adjusted net income level at which the Company Achievement Multiplier will cap at 150%.

If the Company does not achieve the Bonus Trigger, then the Company Achievement Multiplier is set at 0%, and no bonuses are paid under the AEBP.

When adjusted net income falls between the Bonus Trigger and the Bonus Target, the Company Achievement Multiplier will be prorated from 50% to 100%. When adjusted net income falls between the Bonus Target and the Bonus Cap, the Company Achievement Multiplier will be prorated from 100% to 150%. If adjusted net income is greater than the Bonus Cap, the Company Achievement Multiplier will remain capped at 150%.

For 2010, the financial targets for the Company Achievement Multiplier were as follows:

Description	**Adjusted Net Income**		
	Minimum	**Maximum**	**Bonus Percentage**
Below Trigger	$ 0	$ 2,473,000	0%
Trigger to Target	$ 2,473,000	$ 3,440,000	50% to 100% pro rated
Target	$ 3,440,000	$ 3,440,000	100%
Above Target	$ 3,440,000	$ 4,373,000	100% to 150% pro rated
	$ 4,373,000	and above	capped at 150%

Individual Achievement Multiplier. Each executive other than the Chief Executive Officer is assigned objectives by the Chief Executive Officer. The Compensation Committee in conjunction with the Board of Directors determines the Chief Executive Officer s objectives. Objectives for executives other than the Chief Executive Officer may be modified by the Chief Executive Officer during the year in order to suit current business conditions. Objectives are meant to provide guidance and incentive for each executive in the day to day operation of a particular business function.

Each objective carries a particular weighting, with the sum of all objective weightings adding up to 100%.

At the end of the year, the Chief Executive Officer reviews each objective with the particular executive, and determines if the objective was achieved (0% or 100%), or in the case of a prorated objective, what percentage of the objective was achieved. The Chief Executive Officer s determination is reviewed by the Compensation Committee. The Compensation Committee reviews the Chief Executive Officer s achievement of objectives.

The Individual Achievement Multiplier is then determined by multiplying the achievement level of each objective by the assigned weighting for that objective. The results for all objectives are then added together to form the Individual Achievement Multiplier.

For example, if an executive had four objectives, each weighted at 25%, the Individual Achievement Multiplier would be determined as follows:

Individual Achievement Multiplier = *(Objective 1 Achievement % * 25%) + (Objective 2 Achievement % * 25%) + (Objective 3 Achievement % * 25%) + (Objective 4 Achievement % * 25%)*

As noted above, the objective achievement percentage for pass/fail objectives will be 0% or 100%. For prorated objectives, the objective achievement percentage will be prorated between 0% and 100%, inclusive.

Payment of Bonuses. When an executive earns a bonus under the AEBP, the mix of consideration is dependent on the amount of bonus earned. The amount of the bonus which is up to or equal to 35% of the executive s base salary (or prorated base salary if the executive was not with us for the full year) is paid in cash, with the remainder paid in the form of restricted stock units which vest over two years in four equal installments semiannually on the last day of July and December of the two years following the year as to which the bonus is payable (2011 and 2012 with respect to 2010 compensation). The number of restricted stock units in the grant is determined by dividing the non-cash portion of the bonus by the closing price of our common stock on the date of grant.

Generally, the Compensation Committee and Chief Executive Officer will attempt to complete bonus calculations as quickly as possible once the fiscal year ends and our finance team has delivered a stable view of adjusted net income for the year. Once the bonus calculations are complete, they must be presented to and approved by the Board of Directors. If restricted stock units are to be awarded to executives, the grant date will be the date that the AEBP awards are approved by the Board of Directors.

Executives must be employed by us at the end of the measurement year in order to be eligible for a bonus. If an executive leaves the employ of the Company before previously awarded restricted stock units have fully vested, any unvested units will be forfeited.

Computation of 2010 Bonus Amounts.

In 2010, our adjusted net income exceeded the Bonus Cap, and the Company Achievement Multiplier was therefore 150%.

The 2010 Individual Achievement Multipliers for Mr. Crowley and Mr. Mahan were 90% and 93.75%, respectively, determined by their assessed achievement of equally-weighted individual objectives. Mr. Crowley s objectives were (i) achievement of revenue and gross profit targets with demonstration of appropriate cost controls, (ii) completion of a strategic plan for the Company, and (iii) implementation of a system to institutionalize idea generation; and Mr. Mahan s goals were (i) development of a sales acceleration plan, (ii) development and implementation of tax planning strategies, (iii) advancement of the Company s investor relations program and (iv) execution within approved budgets.

As such, the bonus amounts for Mr. Crowley and Mr. Mahan were as follows:

Mr. Crowley: $270,000 * 60% * 150% * 90% = $218,700

Mr. Mahan: $208,000 * 45% * 150% * 93.75% = $131,625

Of these amounts, $94,500 and $72,800 were paid in cash to Mr. Crowley and Mr. Mahan, respectively, representing 35% of their respective base salaries for 2010. The remainder as to each was paid in restricted stock units. The date of grant of these restricted stock units was February 23, 2011, and the closing price of our common stock on that day was $11.83. As such, Mr. Crowley received a grant of 10,498 restricted stock units, and Mr. Mahan received 4,972 restricted stock units.

Incentive Sales Compensation Plan

Sales executives participate in non-equity incentive compensation plans with provisions tailored to the particular individual. The terms of these plans, including the 2010 plan applicable to Mr. McMillan, are determined by agreement with the sales executive each year with respect to a particular year s incentive compensation, but with terms that are subject to change each quarter. The plan applicable to Mr. McMillan for 2010 provided for commissions and bonuses based on Company performance, including percentage commissions on worldwide revenue and worldwide gross profit from particular business lines, and bonuses of fixed dollar amounts payable quarterly based on achievement of revenue and gross profit quotas for those business lines. Percentage commissions based on revenue ranged from 0.18% of revenue to 1.01% of revenue depending on the business line. There are no minimum or maximum amounts payable; percentage commissions depend entirely on the Company s level of achievement with respect to the particular revenue and gross profit measures, while quarterly bonuses are either earned or missed according to whether the particular Company performance quota is met. The plan for 2010 did not include any individual performance criteria, as distinguished from Company performance criteria.

Special 2010 RSU Grants

In August 2010 the Compensation Committee recommended, and the Board of Directors approved, a grant of restricted stock units to certain of our executive officers, the vesting of which was contingent upon our achievement of an adjusted net income target of $3.44 million for 2010. The awards to our named executive officers were in the amounts of 50,000 restricted stock units to Mr. Crowley, and 25,000 restricted stock units to each of Messrs. Mahan and McMillan. These grants were subject to forfeiture in full if the target was not met, and otherwise vest in two equal installments, the first on the date the Compensation Committee determined that the target had been met (which occurred on February 22, 2011) and the second on December 31, 2011.

Other Compensation and Perquisites

Executives are eligible to participate in standard benefit plans available to all employees including the Company s 401(k) retirement plan, medical, dental, disability, vacation and sick leave and life and accident insurance. The same terms apply to all employees for these benefits except where the value of the benefit may be greater for executives due to the fact that they are more highly compensated than most other employees (e.g., disability benefits). However, all executive officers receive a phone allowance of $1,800 per year, as do other employees whose job responsibility requires them to be on call. The individuals receiving the allowance are not reimbursed for normal cell phone usage. We provide no pension or deferred compensation benefits to our executive officers. We do not currently have in place any tax gross-up arrangements with our executives.

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Outstanding Equity Awards at Fiscal Year End

The following table presents the outstanding equity awards held by the named executive officers as of December 31, 2010:

		Option Awards				Stock Awards (5)	
		Number of Securities Underlying Unexercised Options					
Name	**Grant Date**	**Exercisable**	**Unexercisable**	**Option Exercise Price ($) (1)**	**Option Expiration Date (2)**	**Number of Shares or Units of Stock That Have Not Vested (#)**	**Market Value of Shares or Units of Stock That Have Not Vested ($) (6)**
Brian T. Crowley	04/01/2002	25,000		$ 14.40	04/01/2012		
	08/29/2002	16,875		$ 2.88	08/29/2012		
	08/29/2002	1,875		$ 2.88	08/29/2012		
	07/24/2003	75,000		$ 4.00	07/24/2013		
	09/21/2004	125,000		$ 2.32	09/21/2014		
	03/23/2007	46,875	3,125	$ 4.34	03/23/2017(3)		
	03/20/2008	30,938	14,062	$ 3.80	03/20/2018(3)		
	08/03/2010					50,000	$ 437,500
Scott C. Mahan	01/07/2004	37,500		$ 6.47	01/07/2014		
	09/21/2004	62,500		$ 2.32	09/21/2014		
	03/23/2007	32,813	2,187	$ 4.34	03/23/2017(3)		
	03/20/2008	17,188	7,812	$ 3.80	03/20/2018(3)		
	08/03/2010					25,000	$ 218,750
Mark E. McMillan	02/22/2010		50,000	$ 2.34	02/22/2020(4)		
	08/03/2010					25,000	$ 218,750

(1) The option exercise price is set at the closing price of our common stock on the date of grant.
(2) All options outstanding expire ten years from the grant date.
(3) These options vest quarterly over four years from the grant date.
(4) These options vest annually over four years from the grant date.
(5) These awards are restricted stock units granted as incentive plan compensation as described above under Incentive Plan Compensation Special 2010 RSU Grants. On February 22, 2011, the 2010 Company performance criterion was determined to have been met, and on that date these grants vested as to half the underlying shares, with the remaining units vesting on December 31, 2011.
(6) Based on the closing price of our common stock of $8.75 on December 31, 2010.

Employee Benefit Plans

Equity Compensation Plan Information

The following table presents certain information regarding our common stock that may be issued upon the exercise of options and vesting of restricted stock units granted to employees, consultants or directors as of December 31, 2010:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,942,723(1)	$ 3.86	415,419(2)

(1) Amount includes 346,776 restricted stock units granted and unvested as of December 31, 2010.
(2) The Stock Plan provides for an automatic annual increase in the number of shares reserved for issuance by an amount equal to the lesser of: (i) four percent of our outstanding shares at the end of the previous fiscal year, (ii) an amount determined by our Board of Directors, or (iii) 375,000 shares. In February 2011, the number of shares reserved for issuance under the Stock Plan was increased by 375,000 per these terms. The number of securities reflected above in column (c) does not reflect this increase.

Stock Plan

Under the terms of the Stock Plan, we have granted options to purchase common stock to our officers, directors, employees and consultants. Under the terms of the Stock Plan, we also have the ability to issue restricted stock, restricted stock units and certain other equity-based compensation to our officers, directors, employees and consultants. We awarded restricted stock to our directors in 2010. We also awarded restricted stock units to certain employees in 2010.

401(k) Plan

We maintain a tax-qualified 401(k) employee savings and retirement plan for eligible U.S. employees. Eligible employees may elect to defer a percentage of their eligible compensation in the 401(k) plan, subject to the statutorily prescribed annual limit. We may make matching contributions on behalf of all participants in the 401(k) plan in the amount equal to one-half of the first 6% of an employee s contributions. Matching contributions are subject to a vesting schedule; all other contributions are fully vested at all times. We intend the 401(k) plan to qualify under Sections 401(k) and 501 of the Internal Revenue Code of 1986, as amended, so that contributions by employees or the Company to the 401(k) plan and income earned, if any, on plan contributions are not taxable to employees until withdrawn from the 401(k) plan (except as regards Roth contributions), and so that we will be able to deduct our contributions when made. The trustee of the 401(k) plan, at the direction of each participant, invests the assets of the 401(k) plan in any of a number of investment options.

In February 2009, all matching contributions by the Company in the 401(k) plan were suspended in response to overall economic conditions and a need for the Company to proactively manage expenses. In light of improved conditions in the overall economy and in our business, we resumed matching contributions as of August 20, 2010.

STOCK OWNERSHIP

Security Ownership of Principal Shareholders, Directors and Management

The following table sets forth certain information regarding the beneficial ownership of our common stock as of March 31, 2011 as to:

- Each person who is known by us to own beneficially more than five percent of the outstanding shares of common stock;
- Each director and nominee for director of the Company;
- Each of the named executive officers; and
- All of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the SEC. The number of shares listed below under the heading Amount and Nature of Beneficial Ownership is the aggregate beneficial ownership for each shareholder and includes:

- common stock beneficially owned;
- restricted stock awards;
- currently vested options; and
- stock options and restricted stock units that are not currently vested but will become vested within 60 days of March 31, 2011.

Of this total amount, the number of shares of common stock subject to options that are currently vested, and stock options and restricted stock units that are not currently vested but will become vested within 60 days of March 31, 2011 are deemed outstanding for such shareholder (the Deemed Outstanding Shares) and are also separately listed below under the heading Number of Shares Underlying Options and RSUs. For purposes of calculating the number of shares beneficially owned by a shareholder, director or executive officer and resulting percentage ownership, the Deemed Outstanding Shares are not treated as outstanding for the purpose of computing the percentage ownership of common stock outstanding of any other person.

This table is based on information supplied by officers, directors, principal shareholders and filings made with the SEC. Percentage ownership is based on 10,565,623 shares of common stock outstanding as of March 31, 2011.

Unless otherwise noted below, the address for each shareholder listed below is: c/o BSQUARE Corporation, 110 110th Avenue NE, Suite 200, Bellevue, Washington 98004. Unless otherwise noted, each of the shareholders listed below has sole investment and voting power with respect to the common stock indicated, except to the extent shared by spouses under applicable law.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Number of Shares Underlying Options and RSUs	Percent of Common Stock Outstanding
5% Owners:			
Renaissance Technologies LLC (1) 800 Third Ave, 33rd Floor New York, NY 10022	623,130		5.9%
Directors and Executive Officers:			
Donald B. Bibeault (2)	291,438	100,305	2.8%
Elwood D. Howse, Jr. (2)	125,375	96,875	1.2%
Elliott H. Jurgensen, Jr. (3)	164,400	85,850	1.6%
Scot E. Land (2)	125,645	96,875	1.2%
William D. Savoy (2)	110,000	87,500	1.0%
Kendra A. VanderMeulen (2)	100,625	74,125	1.0%
Brian T. Crowley	450,645	362,998	4.3%
Scott C. Mahan	226,235	171,222	2.1%
Mark E. McMillan	45,195	25,000	*
All executive officers and directors as a group (4)	1,646,982	1,100,750	15.6%

* Less than 1%.

(1) The indicated ownership is based solely on a Schedule 13G/A filed with the SEC by the reporting person on February 11, 2011. The beneficial ownership of such reporting person may have changed between such date and March 31, 2011.

(2) Beneficial ownership includes 6,000 unvested restricted stock awards, which are subject to forfeiture.

(3) Beneficial ownership includes 12,000 unvested restricted stock awards, which are subject to forfeiture.

(4) Includes one additional executive officer in addition to the listed named executive officers and directors.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires the Company s executive officers and directors and persons who own more than ten percent of a registered class of the Company s equity securities to file with the SEC reports of ownership on Form 3 and changes in ownership on Form 4 and Form 5. Executive officers, directors and greater-than-ten-percent shareholders are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms they file. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that during the year ended December 31, 2010, its executive officers and directors and persons who own more than ten percent of a registered class of the Company s equity securities complied with all applicable Section 16 filing requirements.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

There were no transactions since January 1, 2009, nor are there any proposed transactions as of the date of this proxy statement, as to which the amount involved exceeds the lesser of $120,000 or one percent of the average of our total assets at year end for the last two completed fiscal years and in which any related person has or will have a direct or indirect material interest, other than equity and other compensation, termination and other arrangements, which are described above under 2010 Director Compensation and Executive Officer Compensation.

PROPOSAL TWO

RATIFY APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Company s Independent Auditors

The independent registered public accounting firm of Moss Adams LLP (Moss Adams) has acted as the Company s auditor since May 2006 and has audited the Company s financial statements for the years ending December 31, 2010 and 2009. Moss Adams is responsible for performing an independent audit of our consolidated financial statements in accordance with auditing standards generally accepted in the United States and issuing a report on its audit. A representative of Moss Adams is expected to be present at the Annual Meeting, where he or she will have the opportunity to make a statement and to respond to appropriate questions.

The Audit Committee s Charter provides that it shall have the sole authority and responsibility to select, evaluate and, if necessary, replace the Company s independent registered public accounting firm. The Audit Committee has selected Moss Adams as the Company s independent registered public accounting firm for the year ending December 31, 2011.

The Audit Committee pre-approves all audit and non-audit services performed by the Company s auditor and the fees to be paid in connection with such services in order to assure that the provision of such services does not impair the auditor s independence. Unless the Audit Committee provides general pre-approval of a service to be provided by the auditor and the related fees, the service and fees must receive specific pre-approval from the Audit Committee.

The Company is asking the shareholders to ratify the appointment of Moss Adams as the independent registered public accounting firm of the Company for the fiscal year ending December 31, 2011. While the Audit Committee will consider the outcome of the shareholder vote, it is not binding. If the shareholders do not ratify this appointment, the Audit Committee will, at its discretion, determine whether to continue with Moss Adams or recommend and appoint a different independent registered public accounting firm.

Audit Fees

Moss Adams billed the Company for audit fees of $240,519 and $232,500 during the years ended December 31, 2010 and 2009, respectively. These audit fees related to professional services rendered in connection with the audit of the Company s annual consolidated financial statements, the reviews of the consolidated financial statements included in each of the Company s quarterly reports on Form 10-Q and accounting services that relate to the audited consolidated financial statements and are necessary to comply with generally accepted auditing standards.

Audit-Related Fees

There were no fees billed for fiscal year 2010 for assurance and related services by Moss Adams that were reasonably related to the performance of its audit of our financial statements and not reported under the caption Audit Fees. Moss Adams billed the Company for audit-related fees of $48,200 for fiscal year 2009. These fees primarily consisted of audit fees associated with our TestQuest, Inc. asset acquisition.

Tax Fees

There were no fees billed for fiscal years 2010 or 2009 for tax compliance, tax advice or tax planning services rendered to the Company by Moss Adams.

All Other Fees

Moss Adams billed the Company $7,000 for fiscal year 2010 in connection with the SEC s review of our Annual Report on Form 10-K for the year ended December 31, 2009. There were no fees billed for fiscal year 2009 for other services rendered to the Company by Moss Adams.

Audit Committee Report

In connection with the Company s financial statements for the fiscal year ended December 31, 2010, the Audit Committee has:

Reviewed and discussed the audited financial statements with management;

Discussed with the Company s independent registered public accounting firm, Moss Adams LLP, the matters required to be discussed by the Statement on Auditing Standards No. 61, as amended (AICPA, Professional Standards, Vol. 1. AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T; and

Received the written disclosures and the letter from the independent registered public accounting firm required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent registered public accounting firm s communications with the Audit Committee concerning independence and discussed with the independent registered public accounting firm the independent registered public accounting firm s independence.

Based upon these reviews and discussions, the Audit Committee approved the Company s audited financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission.

Submitted by the Audit Committee:

Elwood D. Howse, Jr., Chair

Elliott H. Jurgensen, Jr.

Scot E. Land

Vote Required

The ratification of the appointment of Moss Adams LLP as our independent registered public accounting firm requires that the votes cast in favor of the proposal exceed the votes cast against the proposal.

THE BOARD OF DIRECTORS RECOMMENDS THAT SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF MOSS ADAMS LLP AS THE COMPANY S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2011.

OTHER MATTERS

Shareholder Communications with the Board of Directors and Board Attendance at Annual Shareholder Meetings

Our shareholders may, at any time, communicate in writing with any member or group of members of the Board of Directors by sending such written communication to the attention of the Secretary of the Company by regular mail to our principal executive offices, email to investorrelations@bsquare.com or facsimile at 425-519-5998. Copies of written communications received by the Secretary of the Company will be provided to the relevant director(s) unless such communications are considered, in the reasonable judgment of the Secretary of the Company, to be improper for submission to the intended recipient(s). Examples of shareholder communications that would be considered improper for submission include, without limitation, customer complaints, solicitations, communications that do not relate directly or indirectly to the Company or our business, or communications that relate to improper or irrelevant topics.

The Chairperson of the Board of Directors is expected to make all reasonable effort to attend the Company s annual shareholder meeting in person. If the Chairperson is unable to attend an annual shareholder meeting for any reason, at least one other member of the Board of Directors is expected to attend in person. Other members of the Board of Directors are expected to attend the Company s annual shareholder meeting in person if reasonably possible. Messrs. Crowley, Howse, Jurgensen and Savoy and Ms. VanderMeulen attended the 2010 Annual Meeting of Shareholders.

Transaction of Other Business

The Board of Directors of the Company knows of no other matters to be submitted at the Annual Meeting. If any other business is properly brought before the Annual Meeting, proxies will be voted in respect thereof as the proxy holders deem advisable.

Annual Report to Shareholders and Form 10-K

Our Annual Report to Shareholders for the year ended December 31, 2010 (which is not a part of our proxy solicitation materials) is being mailed to our shareholders with this proxy statement. A copy of our Annual Report on Form 10-K for the year ended December 31, 2010, without exhibits, is included with the Annual Report to Shareholders.

By Order of the Board of Directors

Scott C. Mahan

Vice President, Finance & Operations,

Chief Financial Officer, Secretary and Treasurer

Bellevue, Washington

May 4, 2011

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