BSQUARE CORP /WA
Form 10-Q
November 09, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from __________ to __________

Commission File Number: 000-27687

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

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

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

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

The number of shares of common stock outstanding as of October 31, 2006: 9,599,638

BSQUARE CORPORATION
FORM 10-Q
For the Quarterly Period Ended September 30, 2006
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

BSQUARE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,603	$ 7,694
Short-term investments	6,350	1,800
Accounts receivable, net of allowance for doubtful accounts of $689 at September 30, 2006 and $687 at December 31, 2005	6,808	7,296
Prepaid expenses and other current assets	352	440
Total current assets	16,113	17,230
Equipment, furniture and leasehold improvements, net	841	792
Intangible assets, net	152	304
Restricted cash	1,200	1,200
Other non-current assets	52	44
Total assets	$ 18,358	$ 19,570
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,242	$ 2,662
Other accrued expenses	2,972	3,298
Accrued compensation	1,187	964
Accrued legal fees	534	534
Deferred revenue	172	270
Total current liabilities	7,107	7,728
Deferred rent	361	379
Commitments and contingencies (Note 6)		
Shareholders equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 9,592,856 shares issued and outstanding at September 30, 2006 and 9,553,566 shares issued and outstanding at December 31, 2005	118,985	118,393
Accumulated other comprehensive loss	(416)	(423)
Accumulated deficit	(107,679)	(106,507)

Total shareholders equity		10,890		11,463
Total liabilities and shareholders equity	$	18,358	$	19,570

See notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
Software	$ 7,454	$ 7,158	$ 24,354	$ 22,432
Service	4,041	2,938	11,370	7,795
Total revenue	11,495	10,096	35,724	30,227
Cost of revenue:				
Software	5,893	5,783	19,427	17,552
Service (1)	2,775	2,059	8,146	5,988
Total cost of revenue	8,668	7,842	27,573	23,540
Gross profit	2,827	2,254	8,151	6,687
Operating expenses:				
Selling, general and administrative (1)	2,500	2,305	7,524	6,563
Research and development (1)	682	493	2,095	1,326
Total operating expenses	3,182	2,798	9,619	7,889
Loss from operations	(355)	(544)	(1,468)	(1,202)
Interest and other income	120	75	322	217
Loss before income taxes	(235)	(469)	(1,146)	(985)
Income tax expense			(26)	(66)
Net loss	$ (235)	$ (469)	$ (1,172)	$ (1,051)
Basic and diluted loss per share	$ (0.02)	$ (0.05)	$ (0.12)	$ (0.11)
Shares used in calculation of basic and diluted loss per share	9,589	9,542	9,580	9,538

(1) Includes the following amounts related to non-cash stock-based

compensation expense:				
Cost of revenue service	$ 45	$	$ 127	$
Selling, general and administrative	120		332	
Research and development	20		55	
Total stock-based compensation expense	$ 185	$	$ 514	$

See notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2006	2005
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (1,172)	$ (1,051)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	389	253
Stock-based compensation	514	
Other		17
Changes in operating assets and liabilities:		
Accounts receivable, net	492	(2,896)
Prepaid expenses and other assets	81	(6)
Accounts payable and accrued expenses	(522)	1,171
Deferred revenue	(99)	397
Deferred rent	(18)	(13)
Net cash used in operating activities	(335)	(2,128)
Cash flows from investing activities:		
Purchases of equipment and furniture	(287)	(112)
Acquisition of Vibren assets		(500)
Maturities (purchases) of short-term investments, net	(4,550)	5,006
Net cash provided by (used in) investing activities	(4,837)	4,394
Cash flows from financing activities:		
Proceeds from exercise of stock options	78	16
Net cash provided by financing activities	78	16
Effect of exchange rate changes on cash	3	(26)
Net increase (decrease) in cash and cash equivalents	(5,091)	2,256
Cash and cash equivalents, beginning of period	7,694	4,943
Cash and cash equivalents, end of period	$ 2,603	$ 7,199

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006
(unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by BSQUARE Corporation (the Company or BSQUARE) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting and include the accounts of the Company and its subsidiaries. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited financial statements reflect all material adjustments, which consist solely of normal recurring adjustments, necessary to present fairly the Company s financial position as of September 30, 2006 and its operating results and cash flows for the three and nine months ended September 30, 2006 and 2005. The accompanying financial information as of December 31, 2005 is derived from audited financial statements. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provision for bad debts and income taxes, estimates of progress on professional service arrangements and valuation of long-lived assets. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this quarterly report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained in the Company s annual report on Form 10-K for the year ended December 31, 2005 filed with the SEC. All intercompany balances have been eliminated. Certain reclassifications have been made for consistent presentation.

Earnings Per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period and excludes any dilutive effects of common stock equivalent shares. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period, such as stock options and warrants, using the treasury stock method. Common stock equivalent shares are excluded from the computation if their effect is antidilutive. Because the Company had a net loss in each of the periods presented, basic and diluted net loss per share are the same.

As of September 30, 2006, there were stock options and warrants outstanding to acquire 1,865,764 shares of the Company s common stock. As of September 30, 2005, there were stock options and warrants outstanding to acquire 1,597,977 shares of the Company s common stock. These shares were excluded from the computation of diluted loss per share because their effect was antidilutive.

Recent Accounting Pronouncements

In July 2006, FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes,* was issued. This guidance clarifies what criteria must be met prior to recognition of the financial statement benefit of a position taken in a tax return. Additionally, it applies to the recognition and measurement of income tax uncertainties resulting from a purchase business combination. This guidance is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact FIN No. 48 might have on the Company s consolidated results of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective prospectively with a limited form of retrospective application for fiscal years beginning after November 15, 2007 with early adoption encouraged. The Company is currently evaluating the impact that SFAS No. 157 might have on the Company s consolidated results of operations and financial position.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.* This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 is effective prospectively for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact that SFAS No. 158 might have on the Company s consolidated results of operations and financial position.

In September 2006, the SEC released Staff Accounting Bulletin No. 108 Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides interpretative guidance on how public companies quantify financial statement misstatements. There have been two common approaches used to quantify such errors. Under an income statement approach, the roll-over method, the error is quantified as the amount by which the current year income statement is misstated. Alternatively, under a balance sheet approach, the iron curtain method, the error is quantified as the cumulative amount by which the current year balance sheet is misstated.

In SAB 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of a company s financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it requires quantification of errors under both the roll-over and iron curtain methods. SAB 108 is effective for the Company as of January 1, 2007. The Company is currently evaluating the impact that SAB 108 might have on the Company s consolidated results of operations and financial position.

2. Intangible Assets

Intangible assets relate to technology acquired from Vibren Technologies, Inc. in June 2005. The Company s gross carrying value of the acquired intangible assets subject to amortization was $406,000 as of September 30, 2006. Accumulated amortization of these assets as of September 30, 2006 was $254,000. Amortization expense was $51,000 for the three months ended September 30, 2006 and $152,000 for the nine months ended September 30, 2006 and is expected to be $51,000 for the remainder of 2006 and $101,000 in 2007.

3. Stock-Based Compensation

Stock Options

In May 1997, the Company adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board, not to be less than 85% of the fair market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under the Amended Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of the Company s stock. The Amended Plan was amended in 2003 to allow for an automatic annual increase in the number of shares reserved for issuance during each of the Company s fiscal years by an amount equal to the lesser of: (i) four percent of the Company s outstanding shares at the end of the previous fiscal year, (ii) an amount determined by the Company s Board of Directors, or (iii) 375,000 shares. The Amended Plan was further amended in 2005 to allow for awards of stock appreciation rights and restricted and unrestricted stock.

In July 2000, the Company adopted the 2000 Non-Qualified Stock Option Plan (the 2000 Plan). Under the 2000 Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board. These stock options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally over four years.

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Stock-Based Compensation

Effective January 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, (SFAS 123R) as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to December 31, 2005, the Company accounted for stock options according to the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*, and, therefore, no related compensation expense was recorded for awards granted with no intrinsic value. The Company adopted the modified prospective transition method provided for under SFAS 123R, and consequently has not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: 1) compensation cost related to the remaining unvested portion of all stock option awards granted prior to December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and 2) compensation cost related to all stock option awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company records expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

The Company reported a net loss of $235,000, or $0.02 per basic and diluted share, for the three months ended September 30, 2006. Excluding the impact of stock-based compensation expense of $185,000 under FAS123R, the net loss would have been $50,000, or $.01 per basic and diluted share, for that same period.

The Company reported a net loss of $1,172,000, or $0.12 per basic and diluted share, for the nine months ended September 30, 2006. Excluding the impact of stock-based compensation expense of $514,000 under FAS123R, the net loss would have been $658,000, or $0.07 per basic and diluted share, for that same period.

Stock-based compensation expense was recorded on the statement of operations in the same line items as cash compensation for our employees as follows (in thousands):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue service	$ 45	$ 127
Selling, general and administrative	120	332
Research and development	20	55
Total stock-compensation expense	$ 185	$ 514

At September 30, 2006, total compensation cost related to stock options granted to employees under the Company s stock option plans but not yet recognized was $374,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.3 years and will be adjusted for subsequent changes in estimated forfeitures.

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Key Assumptions

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

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
	SFAS 123R	SFAS 123	SFAS 123R	SFAS 123
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	90%	101%	94%	102%
Risk-free interest rate	4.8%	4.2%	4.8%	4.0%
Estimated forfeitures	36%	n/a	37%	n/a

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

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

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

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

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

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Stock Option Activity

The following table summarizes activity under the Company s stock option plans for the nine months ended September 30, 2006:

Stock Options	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)		Aggregate Intrinsic Value
Outstanding at January 1, 2006	1,760,368	$	4.75			
Granted at fair value	219,500		2.66			
Exercised	(39,290)		2.08			
Forfeited	(88,243)		3.02			
Expired	(86,571)		10.44			
Outstanding at September 30, 2006	1,765,764	$	4.36	7.84	$	73,847
Vested and expected to vest at September 30, 2006	1,487,083	$	4.64	0.28	$	72,804
Exercisable at September 30, 2006	1,062,803	$	5.31	7.17	$	70,352

The weighted-average grant-date fair value was $2.00 per share for options granted during the nine months ended September 30, 2006. The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of the Company s common stock as of September 30, 2006 for the 184,834 options that were in-the-money at September 30, 2006. The Company issues new shares of common stock upon exercise of stock options. The aggregate intrinsic value of options exercised under the Company s stock option plans was $43,000 for the nine months ended September 30, 2006.

Pro Forma Disclosure

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company s stock-based compensation plans prior to January 1, 2006:

(in thousands, except per share amounts)		Three Months Ended September 30, 2005		Nine Months Ended September 30, 2005
Net loss, as reported	$	(469)	$	(1,051)
Compensation expense recognized under APB 25		17		17
Pro forma employee compensation expense under SFAS 123		(208)		(638)
Pro forma net loss	$	(660)	$	(1,672)

Basic and diluted loss per share, as reported	$	(0.05)	$	(0.11)
Pro forma basic and diluted loss per share	$	(0.07)	$	(0.18)
Shares used to calculate pro forma basic and diluted loss per share		9,542		9,538

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4. Comprehensive Loss

Comprehensive loss is defined as the change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. The difference between net loss and comprehensive loss for the Company is attributable to foreign currency translation adjustments.

Components of comprehensive loss consist of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net loss	$ (235)	$ (469)	$ (1,172)	$ (1,051)
Foreign currency translation gain (loss)	(8)	(40)	7	(26)
Comprehensive loss	$ (243)	$ (509)	$ (1,165)	$ (1,077)

5. Taxes

In the second quarter of 2005, the Company became aware that certain amounts remitted, or that were planned to be remitted, from its Taiwan subsidiary or Taiwanese customers, might be subject to withholding tax at 20% of the amount remitted. In the fourth quarter of 2005, the Company began applying for withholding tax exemptions from the Taiwan government on all significant contracts on which withholding tax might be owed. If granted, these exemptions eliminate any withholding tax for the contract to which the exemption relates. To date, the Company has received approval for all withholding exemption applications that it has filed for which significant withholding tax might be owed. However, there is no assurance that future exemptions will be granted and if the Company does not receive all, or some, of the exemptions for which it applies, it could be obligated to pay withholding tax in the future. Management is continuing to evaluate alternative business and tax planning strategies to minimize corporate income and withholding tax obligations in connection with its Taiwan subsidiary.

6. Commitments and Contingencies

Contractual Commitments

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

In the event the Company was to default under its current corporate headquarters lease, the landlord has the ability to demand payment for a portion of cash payments forgiven in 2004 under its former headquarters lease. The amount of the forgiven payments that the landlord has the ability to demand repayment for decreases on the straight-line basis over the length of the current ten-year headquarters lease. Cash payments for which the landlord has the ability to demand repayment were $1.9 million at September 30, 2006. The lease agreement for the new corporate headquarters contains a lease escalation clause calling for increased rents during the second half of the ten-year lease.

Rent expense was $256,000 for the three months ended September 30, 2006 and $224,000 for the three months ended September 30, 2005. Rent expense was $783,000 for the nine months ended September 30, 2006 and $604,000 for the nine months ended September 30, 2005.

As of September 30, 2006, the Company had $1.2 million pledged as collateral for a bank letter of credit under the terms of its headquarters facility lease. The pledged cash supporting the outstanding letter of credit is presented

as restricted cash.
Contractual lease commitments at September 30, 2006 were as follows (in thousands):

Operating leases:	
Remainder of 2006	$ 279
2007	1,024
2008	952
2009	853
2010	926
Thereafter	3,864
Total commitments	$ 7,898

Legal Proceedings

IPO Litigation

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

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

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On July 15, 2002, the Company moved to dismiss all claims against it and the Individual Defendants. On October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice based upon Stipulations of Dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the Court denied the motion to dismiss the complaint against the Company. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants sought leave to appeal this decision and the Second Circuit has accepted the appeal. Plaintiffs have not yet moved to certify a class in the Company s case. The Company has approved a settlement agreement and related agreements which set forth the terms of a settlement between the Company, the Individual Defendants, the plaintiff class and the vast majority of the other approximately 300 issuer defendants. Among other provisions, the settlement provides for a release of the Company and the Individual Defendants for the conduct alleged in the action to be wrongful. The Company would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. The settlement agreement also provides a guaranteed recovery of $1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least $1 billion, no payment will be required under the issuers settlement agreement. On April 20, 2006, JPMorgan Chase and the plaintiffs reached a preliminary agreement for a settlement of $425 million. The JPMorgan Chase settlement has not yet been approved by the Court. However, if it is finally approved, then the maximum amount that the issuers insurers will be potentially liable for is $575 million. To the extent that the underwriter defendants settle for less than $1 billion, the issuers are required to make up the difference. It is anticipated that any potential financial obligation of the Company to plaintiffs pursuant to the terms of the settlement agreement and related agreements will be covered by existing

insurance. The Company currently is not aware of any material limitations on the expected recovery of any potential financial obligation to plaintiffs from its insurance carriers. Its carriers are solvent, and the Company is not aware of any uncertainties as to the legal sufficiency of an insurance claim with respect to any recovery by plaintiffs. Therefore, we do not expect that the settlement will involve any payment by the Company. If material limitations on the expected recovery of any potential financial obligation to the plaintiffs from the Company s insurance carriers should arise, the Company s maximum financial obligation to plaintiffs pursuant to the settlement agreement would be less than $3.4 million. However, if the JPMorgan Chase settlement is finally approved, the Company s maximum financial obligation to the plaintiffs pursuant to the settlement agreement would be less than $2 million. On February 15, 2005, the court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. Those modifications have been made. On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but it has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the settlement agreement is not approved and the Company is found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company s insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.

Customer Litigation

As previously reported, the Company has been in dispute with a former customer (Former Customer) regarding payment of amounts due for a contract under which the Company provided professional engineering services. The Company has an account receivable outstanding with this former customer of $475,000 as of September 30, 2006 and increased the allowance for doubtful accounts by $475,000 in the fourth quarter of 2005 related to this account receivable. As a result of the dispute, the Company filed a Complaint for breach of contract and misappropriation of intellectual property against the Former Customer on December 22, 2005 in federal district court in the state of Delaware. On January 27, 2006, the Former Customer filed an Answer and Counterclaim against the Company, and the Company filed its Reply to the Former Customer s Answer and Counterclaim on February 16, 2006, denying all counterclaims against it.

On October 31, 2006, the Company and the Former Customer settled their dispute by entering into a settlement agreement (the Settlement Agreement). Under the Settlement Agreement, the Former Customer has agreed to pay a Settlement Amount of $200,000 to the Company on or before December 31, 2009 and also provide certain intellectual property to the Company, under a license agreement. The Former Customer made an initial payment of $10,000 upon execution of the Settlement Agreement. The remaining amount owed to the Company under the Settlement Agreement will be satisfied through the purchase of Microsoft embedded operating systems from the Company or through commissions and royalties earned by the Company related to the sale of the Former Customer s intellectual property. The Former Customer s parent company has placed its common stock in escrow to guarantee performance under the Settlement Agreement, including an agreement that the Settlement Amount is satisfied by December 31, 2009. Additionally, the Settlement Agreement provides that all claims between the parties are terminated. The settlement structure provides for the possibility of ongoing commission and royalty revenue to the Company after the satisfaction of the $200,000 settlement amount such that the total recovery may be greater than $200,000.

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7. Segment Information

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

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

	Three Months Ended September 30,		Nine Months Ended June 30,	
	2006	2005	2006	2005
Total revenue:				
North America	$ 10,950	$ 9,742	$ 33,651	$ 28,694
Asia	535	332	2,022	1,407
Other foreign	10	22	51	126
Total revenue (1)	$ 11,495	$ 10,096	$ 35,724	$ 30,227

	September 30, 2006	December 31, 2005
Long-lived assets:		
North America	$ 946	$ 1,047
Asia	47	49
Total long-lived assets	$ 993	$ 1,096

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

8. Related Party Transactions

Pursuant to a consulting agreement between the Company and Mr. Donald Bibeault, the Chairman of the Company s Board of Directors, Mr. Bibeault has provided the Company with onsite consulting services since July 2003, when he was appointed to the Company s Board of Directors. The Company incurred expenses of $24,000 for the three months ended September 30, 2006 and $72,000 for the nine months ended September 30, 2006 under this consulting agreement. The Company incurred expenses of $24,000 for the three months ended September 30, 2005 and $89,000 for the nine months ended September 30, 2005 under this consulting agreement.

On June 29, 2006, the Company and Mr. Bibeault agreed to terminate the Company s consulting agreement, effective September 30, 2006. Mr. Bibeault will continue to serve as the Chairman of the Company s Board of Directors.

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

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

Overview

We provide software and engineering service offerings to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) and may be connected to a network via a wired or wireless connection. Examples of smart devices that we target include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, personal digital assistants (PDAs), personal media players and smartphones. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile for Pocket PC and Smartphone.

We have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class Original Equipment Manufacturers (OEMs), Original Design Manufacturers (ODMs), silicon vendors (SVs), peripheral vendors, and enterprises that develop, market and distribute connected smart devices. The software and engineering services we provide our customers are utilized and deployed throughout various phases of our customers device life cycle, including design, development, customization, quality assurance and deployment.

Critical Accounting Judgments

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company s critical accounting policies as those that are most important to the portrayal of our financial condition and results of operations, and those that require us to make our most difficult and subjective judgments, often as a result of the need to make estimates related to matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are relevant to understanding our results. For additional information see Note 1 Description of Business and Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2005 and Item 1 of Part I, Financial Statements Note 1 Summary of Significant Accounting Policies. Although we believe that our estimates, assumptions and judgments are reasonable, they are necessarily based upon presently available information. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

Revenue Recognition

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

We recognize revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support or maintenance (PCS). As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. PCS includes rights to upgrades, when and if available, telephone support, updates, and enhancements. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. Accordingly, the judgments involved in assessing VSOE have an impact on the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition but would not change the total revenue recognized on the contract.

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

Service revenue from fixed-priced contracts is recognized using the percentage of completion method. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. We rely on estimates of total expected hours as a measure of performance and cost in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period the facts that give rise to the revision become known. Service revenue from time and materials contracts and training services is recognized as services are performed.

Stock-Based Compensation

In May 1997, we adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board, not to be less than 85% of the fair market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under the Amended Plan may only be granted to our employees, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of our common stock. The Amended Plan was amended in 2003 to allow for an automatic annual increase in the number of shares reserved for issuance during each of our fiscal years by an amount equal to the lesser of: (i) four percent of our outstanding common stock at the end of the previous fiscal year, (ii) an amount determined by our Board of Directors, or (iii) 375,000 shares. The

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Amended Plan was further amended in 2005 to allow for awards of stock appreciation rights and restricted and unrestricted stock.

In July 2000, we adopted the 2000 Non-Qualified Stock Option Plan (the 2000 Plan). Under the 2000 Plan, the Board of Directors may grant non-qualified stock options at a price determined by the Board. These stock options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally over four years.

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, (SFAS 123R) as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to December 31, 2005, we accounted for stock options according to the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*, and, therefore, no related compensation expense was recorded for awards granted with no intrinsic value. We adopted the modified prospective transition method provided for under SFAS 123R, and consequently has not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: 1) compensation cost related to the remaining unvested portion of all stock option awards granted prior to December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and 2) compensation cost related to all stock option awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We recognize expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

At September 30, 2006, the total compensation cost related to stock options granted to employees under our stock option plans but not yet recognized was $374,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.3 years and will be adjusted for subsequent changes in estimated forfeitures.

Allowance for Doubtful Accounts

Our accounts receivable balance is net of an estimated allowance for doubtful accounts. We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We estimate the collectability of our accounts receivable and record an allowance for doubtful accounts. We consider many factors including analyzing accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history when evaluating the adequacy of the allowance for doubtful accounts. We have an account receivable outstanding of $475,000 as of September 30, 2006 with a former customer and increased the allowance for doubtful accounts by $475,000 in the fourth quarter of 2005 related to this account receivable. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimated reserve.

Taxes

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

In the second quarter of 2005, we became aware that certain amounts remitted, or that were planned to be remitted, from our Taiwan subsidiary or Taiwanese customers might be subject to withholding tax at 20% of the amount remitted. In the fourth quarter of 2005, we began applying for withholding tax exemptions from the Taiwan government on all significant contracts on which withholding tax might be owed. If granted, these exemptions eliminate any withholding tax for the contract to which the exemption relates. To date, we have received approval for all withholding exemption applications that we have filed for which significant withholding tax might be owed. However, there is no assurance that future exemptions will be granted and if we do not receive all, or some, of the exemptions for which we apply, we could be obligated to pay withholding tax in the future. We are continuing to evaluate alternative business and tax planning strategies to minimize corporate income and withholding tax obligations in connection with our Taiwan subsidiary.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Revenue:				
Software	65%	71%	68%	74%
Service	35	29	32	26
Total revenue	100	100	100	100
Cost of revenue:				
Software	51	58	54	58
Service	24	20	23	20
Total cost of revenue	75	78	77	78
Gross profit	25	22	23	22
Operating expenses:				
Selling, general and administrative	22	22	21	22
Research and development	6	5	6	4
Total operating expenses	28	27	27	26
Loss from operations	(3)	(5)	(4)	(4)
Interest and other income	1	0	1	1
Loss before income taxes	(2)	(5)	(3)	(3)
Income tax expense	0	0	0	0
Net loss	(2)%	(5)%	(3)%	(3)%

Revenue

Total revenue consists of sales of software and engineering services to smart device makers. Software revenue consists of the sale of third-party software and sales of our own proprietary software products which includes royalties from our software products, software development kits and smart device reference designs. Engineering service revenue is derived from hardware and software development, maintenance and support contracts, fees for customer training, and rebillable expenses.

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Total revenue was $11.5 million for the three months ended September 30, 2006 and $10.1 million for the three months ended September 30, 2005, representing an increase of $1.4 million, or 14%. Total revenue was $35.7 million for the nine months ended September 30, 2006 and $30.2 million for the nine months ended September 30, 2005, representing an increase of $5.5 million, or 18%. These increases are discussed further below.

Revenue from customers located outside of the United States includes revenue attributable to our foreign operations, as well as software and engineering services sold to foreign customers from our operations located in the United States. We currently have international sales operations in Taipei, Taiwan and Tokyo, Japan. In the fourth quarter of 2003, we closed our Japan operations, but re-established a direct sales presence in Tokyo, Japan, in the fourth quarter of 2005. Revenue from customers located outside of North America was $545,000 for the three months ended September 30, 2006 and $354,000 for the three months ended September 30, 2005, representing an increase of $191,000, or 54%. Revenue from customers located outside of the North America was $2.1 million for the nine months ended September 30, 2006 and $1.5 million for the nine months ended September 30, 2005, representing an increase of $600,000, or 40%. This increase was primarily due to an increase in service revenue in Taiwan. Billable hours in Taiwan for the nine months ended September 30, 2006 increased 241% from the same period last year.

Software revenue

Software revenue is presented below (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Software revenue:				
Third-party software	$ 6,960	$ 6,667	$ 22,611	$ 20,385
BSQUARE proprietary software	494	491	1,743	2,047
Total software revenue	$ 7,454	$ 7,158	$ 24,354	$ 22,432
Software revenue as a percentage of total revenue	65%	71%	68%	74%
Third-party software revenue as a percentage of total software revenue	93%	93%	93%	91%

The vast majority of our third-party software revenue is comprised of the resale of Microsoft Embedded operating systems. The majority of our proprietary software revenue is attributable to sales of our SDIO Now! software product.

Software revenue was $7.5 million for the three months ended September 30, 2006 and $7.2 million for the three months ended September 30, 2005, representing an increase of $300,000, or 4%. This increase was almost entirely due to higher third-party software revenue of $293,000. Software revenue was $24.4 million for the nine months ended September 30, 2006 and $22.4 million for the nine months ended September 30, 2005, representing an increase of $2.0 million, or 9%. This increase was primarily due to higher third-party software revenue of $2.2 million, partially offset by a decrease of $304,000 in proprietary software revenue. The increases in third-party software sales in 2006 for both the three- and nine-month periods were primarily attributable to an increase in sales to new accounts obtained through a customer referral arrangement entered into in the fourth quarter of 2005. We expect third-party software sales in the fourth quarter of 2006 to increase approximately 20% from the third quarter of 2006 based on the strength of customer sales activities.

Proprietary software revenue was $494,000 for the three months ended September 30, 2006 and $491,000 for the three months ended September 30, 2005, representing an increase of $3,000, or 1%. Proprietary software revenue was $1.7 million for the nine months ended September 30, 2006 and $2.0 million for the nine months ended September 30, 2005, representing a decrease of $300,000, or 15%. The decrease in 2006 in proprietary software revenue for the nine month period was the result of $300,000 in revenue recognized in the second quarter of 2005 relating to previously underreported non-SDIO royalties from an OEM. We expect proprietary software revenue to increase approximately 50% in the fourth quarter of 2006 as compared to the third quarter of 2006 based on renewed strength of SDIO Now! product sales and increased reference design and related product sales.

Service revenue

Service revenue was $4.0 million for the three months ended September 30, 2006 and $2.9 million for the three months ended September 30, 2005, representing an increase of $1.1 million, or 38%. Service revenue represented 35% of total revenue for the three months ended September 30, 2006 and 29% of total revenue for the three months ended September 30, 2005. The increase in service revenue was primarily due to a 44% increase in billable hours from the same period last year, partially offset by a 9% decrease in the realized rate per hour. Service revenue was $11.4 million for the nine months ended September 30, 2006 and $7.8 million for the nine months ended September 30, 2005, representing an increase of $3.6 million, or 46%. Service revenue represented 32% of total revenue for the nine months ended September 30, 2006 and 26% of total revenue for the nine months ended September 30, 2005. The increase in service revenue was primarily due to a 63% increase in billable hours from the same period last year, partially offset by a 11% decrease in the realized rate per hour. The increase in billable hours was due to higher activity levels driven by overall market strength, sales improvements and improved personnel utilization. The decrease in realized rate per hour resulted from the impact of several Asia Pacific contracts on which we are providing engineering services at relatively low rates in exchange for guaranteed royalty payments in the future. We expect service revenue to increase approximately 10% in the fourth quarter of 2006 as compared to the third quarter of 2006 due to the strengthening of our services sales pipeline and the fact that our utilization was negatively impacted in the early part of the third quarter of 2006, something we do not expect to reoccur in the fourth quarter of 2006.

Gross profit

Gross profit is revenue less the cost of revenue. Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software and the costs of product media, product duplication and manuals. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, plus related facilities and depreciation costs.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(Unaudited)		(Unaudited)	
Software gross profit	$1,561	$1,375	$4,927	$4,880
As a percentage of total software revenue	21%	19%	20%	22%
Service gross profit	$1,266	$ 879	$3,224	$1,807
As a percentage of service revenue	31%	30%	28%	23%
Total gross profit	$2,827	$2,254	$8,151	$6,687
As a percentage of total revenue	25%	22%	23%	22%

Software gross profit

Software gross profit as a percentage of software revenue was 21% for the three months ended September 30, 2006 and 19% for the three months ended September 30, 2005. The increase in software gross profit percentage was driven by an increase in the third-party software gross profit percentage discussed further below. Software gross profit as a percentage of software revenue was 20% for the nine months ended September 30, 2006 and 22% for the nine months ended September 30, 2005. The decrease in software gross profit percentage for the nine month period was primarily due to an increase in low margin third-party software revenue and a decrease in high margin proprietary software sales as percentages of total software revenue. Third-party software revenue typically generates a much lower profit margin than our proprietary software whereas our proprietary software revenue has traditionally generated high profit margins. We expect profit margins on our proprietary software sales to remain at a relatively high level for the foreseeable future. Third-party software gross profit as a percentage of third-party software revenue was 16.6% for the three months ended September 30, 2006 compared to 14.2% for the three months ended September 30, 2005. We expect the third-party software profit percentage to decline in the fourth quarter of 2006 to the 14-15% range; more consistent with our historical averages. We expect third-party software sales to continue to be a significant percentage of our overall software revenue, and, therefore, our overall software gross profit is likely to remain relatively low in the foreseeable future. We also expect continued pressure on third-party gross profits due to competition in the marketplace. Our objective is to raise overall software gross profit in the future as we seek to increase sales of our own, high margin, proprietary software products, both in absolute dollars and as a percentage of overall software revenue.

Service gross profit

Service gross profit was $1,266,000 for the three months ended September 30, 2006 and $879,000 for the three months ended September 30, 2005, representing an increase of $387,000, or 44%. Service gross profit was $3.2 million for the nine months ended September 30, 2006 and $1.8 million for the nine months ended September 30, 2005, representing an increase of $1.4 million, or 78%. Service gross profit as a percentage of service revenue was 31% for the three months ended September 30, 2006, compared to 30% for the three months ended September 30, 2005 and 28% for the nine months ended September 30, 2006, compared to 23% for the nine months ended September 30, 2005. The overall improvement in service gross profit is attributable to increased service revenue, improved resource utilization, pricing and contract management partially offset by a decrease in realized rate per hour for the reasons discussed previously. Until the end of the second quarter of 2005, we generally employed more service engineering personnel than near-term service engineering demands dictated such that as revenue levels increased in mid-2005, the service gross profit margin increased accordingly. In addition, our facilities and depreciation costs, a portion of which is included in service cost of revenue, are relatively fixed and are being spread over a larger revenue base and other areas within the company. We expect service margin to continue to improve in the fourth quarter of 2006 as revenue levels increase and some costs, particularly fringe benefit expense, decline.

Operating expenses

Selling, general and administrative

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

Selling, general and administrative expenses were $2.5 million for the three months ended September 30, 2006 and $2.3 million for the three months ended September 30, 2005, representing an increase of $200,000, or 9%. Selling, general and administrative expenses represented 22% of total revenue for the three months ended September 30, 2006 and 22% for the three months ended September 30, 2005. Selling, general and administrative expenses were $7.5 million for the nine months ended September 30, 2006 and $6.6 million for the nine months ended September 30, 2005, representing an increase of $900,000, or 14%. Selling, general and administrative expenses represented 21% of total revenue for the nine months ended September 30, 2006 and 22% of total revenue for the nine months ended September 30, 2005.

These increases noted above were due to higher personnel and facilities costs in 2006 as compared to 2005. Personnel costs increased due to stock-based compensation expense of $120,000 for the three months ended September 30, 2006 and $332,000 for the nine months ended September 30, 2006 related to the adoption of SFAS 123R whereas there was none for the comparable periods in 2005. The remainder of the increases for both the three- and nine-month periods relate to increases in sales personnel costs, including bonuses and commissions, both domestically and internationally, as we have grown our sales force in light of increasing market opportunity and personnel costs associated with the Vibren acquisition in June 2005. We expect selling, general and administrative costs to remain relatively flat in the fourth quarter of 2006 as compared to the third quarter of 2006 with the exception of costs that might be incurred relative to our Sarbanes-Oxley compliance efforts.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, and related facilities and depreciation costs.

Research and development expenses were $682,000 for the three months ended September 30, 2006 and $493,000 for the three months ended September 30, 2005, representing an increase of $189,000, or 38%. Research and development expenses represented 6% of our total revenue for the three months ended September 30, 2006 and 5% for the three months ended September 30, 2005. Research and development expenses were $2.1 million for the nine months ended September 30, 2006 and $1.3 million for the nine months ended September 30, 2005, representing an increase of $800,000, or 62%. Research and development expenses represented 6% of our total revenue for the nine months ended September 30, 2006 and 4% for the nine months ended September 30, 2005.

The increases noted above were specifically attributable to increased payroll and related expenses resulting from headcount growth, as well as increased headcount-based facilities expense allocations. Overall, research and development expense has increased as we have increased our focus on expanding our proprietary software products portfolio, particularly during the second half of 2005. We are continuing to execute and evolve our product strategy, but expect no significant increase in research and development expenses in the fourth quarter of 2006 as compared to the third quarter of 2006 on our current product plans.

Interest and other income

Interest and other income consists of interest earnings on our cash, cash equivalents, short-term investments and restricted cash. Interest and other income was $120,000 for the three months ended September 30, 2006 and $75,000 for the three months ended September 30, 2005, representing an increase of $45,000, or 60%. Interest and other income was $322,000 for the nine months ended September 30, 2006 and $217,000 for the nine months ended September 30, 2005, representing an increase of $105,000, or 48%. These increases were due to higher prevailing interest rates in 2006 as compared to 2005, partially offset by lower average cash, cash equivalents and short-term investments balances.

Income Tax Expense

Income tax expense was zero for the three months ended September 30, 2006 and zero for the three months ended September 30, 2005. Income tax expense was $26,000 for the nine months ended September 30, 2006 and $66,000 for the nine months ended September 30, 2005, representing a decrease of $40,000, or 61%. As of September 30, 2005, our Taiwan subsidiary had utilized all of its net operating loss carryforwards available at that time. As a result, we recognized income tax expense of $66,000 during the nine months ended September 30, 2005. We incurred $26,000 in income tax expense for the nine months ended September 30, 2006 as a result of additional income taxes and undistributed dividends tax owed for 2005 related to our Taiwan subsidiary. Income tax expense for the remainder of 2006 will be dependent on the results of our Taiwan subsidiary as well as on the potential affect of tax withholding expense due on international sales.

Liquidity and Capital Resources

As of September 30, 2006, we had $9.0 million of cash, cash equivalents and short-term investments compared to $9.5 million at December 31, 2005. Both of those balances exclude $1.2 million in cash restricted to secure our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital at September 30, 2006 was $9.0 million compared to $9.5 million at December 31, 2005. The decrease in working capital was primarily due to our net loss for the nine months ended September 30, 2006 offset by non-cash expenses.

During the nine months ended September 30, 2006, net cash used by operating activities was $335,000. This cash use was primarily attributable to our net loss of $1.2 million, offset by the effect of non-cash expenses totaling

$903,000. During the nine months ended September 30, 2005, net cash used in operating activities was $2.1 million. This cash use was attributable to our net loss of $1.1 million during the period and an increase in accounts receivable of $2.9 million due primarily as a result of realizing sales late in the third quarter of 2005.

Net cash used in investing activities was $4.8 million for the nine months ended September 30, 2006 compared to net cash provided by investing activities of $4.4 million for the nine months ended September 30, 2005. Investing activities in 2006 included $4.6 million used in purchases of short-term investments and $287,000 used to purchase capital equipment. Investing activities in 2005 included $5.0 million in maturities of short-term investments, partially offset by $500,000 paid to purchase certain assets from Vibren and $112,000 used to purchase equipment. We expect to invest approximately $100-150,000 in capital expenditures for the remainder of the year.

Financing activities generated $78,000 for the nine months ended September 30, 2006 and $16,000 for the nine months ended September 30, 2005 as a result of proceeds from stock option exercises.

Tabular Disclosure of Contractual Obligations

We have significant lease commitments, which expire through 2014. We have operating lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Vancouver, British Columbia and Taipei, Taiwan. The following are our contractual commitments associated with these lease and other obligations (in thousands):

	Payments Due through Year Ended December 31:						
Contractual Obligations	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**	**Total**
Long-term debt obligations	$	$	$	$	$	$	$
Equipment financing obligations							
Operating lease obligations	279	1,024	952	853	926	3,864	7,898
Purchase obligations							
Other long-term obligations							
Total	$ 279	$ 1,024	$ 952	$ 853	$ 926	$ 3,864	$ 7,898

In addition, in the event we were to default under our current corporate headquarters lease, the landlord has the ability to demand payment for cash payments forgiven in 2004 under our former headquarters lease. The amount of the forgiven payments that the landlord has the ability to demand repayment for decreases on the straight-line basis over the length of the current ten-year headquarters lease. Cash payments for which the landlord has the ability to demand repayment were $1.9 million at September 30, 2006.

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

Related Party Transactions

Pursuant to a consulting agreement between us and Mr. Donald Bibeault, the Chairman of our Board of Directors, Mr. Bibeault has provided us with onsite consulting services since July 2003, when he was appointed to our Board of Directors. We incurred expenses of $24,000 for the three months ended September 30, 2006 and $72,000 for the nine months ended September 30, 2006 under this consulting agreement. We incurred expenses of $24,000 for the three months ended September 30, 2005 and $89,000 for the nine months ended September 30, 2005 under this consulting agreement.

On June 29, 2006, we and Mr. Bibeault agreed to terminate this consulting agreement, effective September 30, 2006. Mr. Bibeault will continue to serve as the Chairman of our Board of Directors.

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Impact of New Accounting Pronouncements

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, (SFAS 123R) as interpreted by SEC Staff Accounting Bulletin No. 107. The following table presents stock-based compensation expense as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Cost of revenue service	$ 45	$	$ 127	$
Selling, general and administrative	120		332	
Research and development	20		55	
Total stock-based compensation expense	$ 185	$	$ 514	$

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk. We do not hold derivative financial instruments or equity securities in our short-term investment portfolio. Our cash equivalents consist of high-quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one issue to a maximum of 15% and any one issuer to a maximum of 10% of the total portfolio with the exception of treasury securities, commercial paper and money market funds, which are exempt from size limitation. The policy limits all short-term investments to those with maturities of two years or less, with the average maturity being one year or less. These securities are subject to interest rate risk and will decrease in value if interest rates increase.

Foreign Currency Exchange Rate Risk. Currently, the majority of our revenue and expenses is denominated in U.S. dollars, and, as a result, we have not experienced significant foreign exchange gains and losses to date. While we have conducted some transactions in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant. We have not engaged in foreign currency hedging to date, although we may do so in the future.

Our exposure to foreign exchange rate fluctuations can vary as the financial results of our foreign subsidiaries are translated into U.S. dollars in consolidation. The effect of foreign exchange rate fluctuations for the three and nine months ended September 30, 2006 and September 30, 2005 was not material.

Item 4. Controls and Procedures

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

(b) Changes in internal control over financial reporting. There has been no change in our internal control over financial reporting during the nine months ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

IPO Litigation

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

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

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On July 15, 2002, we moved to dismiss all claims against us and the Individual Defendants. On October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice based upon Stipulations of Dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the Court denied the motion to dismiss the complaint against us. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants sought leave to appeal this decision and the Second Circuit has accepted the appeal. Plaintiffs have not yet moved to certify a class in our case. We have approved a settlement agreement and related agreements which set forth the terms of a settlement between us, the Individual Defendants, the plaintiff class and the vast majority of the other approximately 300 issuer defendants. Among other provisions, the settlement provides for a release of us and the Individual Defendants for the conduct alleged in the action to be wrongful. We would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims we may have against our underwriters. The settlement agreement also provides a guaranteed recovery of $1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least $1 billion, no payment will be required under the issuers settlement agreement. On April 20, 2006, JPMorgan Chase and the plaintiffs reached a preliminary agreement for a settlement of $425 million. The JPMorgan Chase settlement has not yet been approved by the Court. However, if it is finally approved, then the maximum amount that the issuers insurers will be potentially liable for is $575 million. To the extent that the underwriter defendants settle for less than $1 billion, the issuers are required to make up the difference. It is anticipated that any potential financial obligation of the Company to plaintiffs pursuant to the terms of the settlement agreement and related agreements will be covered by existing insurance. We currently are not aware of any material limitations on the expected recovery of any potential financial obligation to plaintiffs from our insurance carriers. Our carriers are solvent, and we are not aware of any uncertainties as to the legal sufficiency of an insurance claim with respect to any recovery by plaintiffs. Therefore, we do not expect that the settlement will involve any payment by us. If material limitations on the expected recovery of any potential financial obligation to the plaintiffs from our insurance carriers should arise, our maximum financial obligation to plaintiffs pursuant to the settlement agreement would be less than $3.4 million. However, if the JPMorgan Chase settlement is finally approved, our maximum financial obligation to the plaintiffs pursuant to the settlement agreement would be less than $2 million. On February 15, 2005, the court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. Those modifications have been made. On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but it has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the settlement agreement is not approved and we are found

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liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.

Customer Litigation

As previously reported, we have been in dispute with a former customer (Former Customer) regarding payment of amounts due for a contract under which we provided professional engineering services. We have an account receivable outstanding with this former customer of $475,000 as of September 30, 2006 and increased the allowance for doubtful accounts by $475,000 in the fourth quarter of 2005 related to this account receivable. As a result of the dispute, we filed a Complaint for breach of contract and misappropriation of intellectual property against the Former Customer on December 22, 2005 in federal district court in the state of Delaware. On January 27, 2006, the Former Customer filed an Answer and Counterclaim against us, and we filed our Reply to the Former Customer s Answer and Counterclaim on February 16, 2006, denying all counterclaims against us.

On October 31, 2006, we and the Former Customer settled this dispute by entering into a settlement agreement (the Settlement Agreement). Under the Settlement Agreement, the Former Customer has agreed to pay a Settlement Amount of $200,000 to us on or before December 31, 2009 and also provide certain intellectual property to us, under a license agreement. The Former Customer made an initial payment of $10,000 upon execution of the Settlement Agreement. The remaining amount owed to us under the Settlement Agreement will be satisfied through the purchase of Microsoft embedded operating systems from us or through commissions and royalties earned by us related to the sale of the Former Customer s intellectual property. The Former Customer s parent company has placed its common stock in escrow to guarantee performance under the Settlement Agreement, including an agreement that the Settlement Amount is satisfied by December 31, 2009. Additionally, the Settlement Agreement provides that all claims between the parties are terminated. The settlement structure provides for the possibility of ongoing commission and royalty revenue to us after the satisfaction of the $200,000 settlement amount such that the total recovery may be greater than $200,000.

Item 1A. ***Risk Factors.***

The following risk factors and other information included in this Quarterly Report on Form 10-Q should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

If we do not maintain our OEM Distribution Agreement with Microsoft, our revenue would decrease and our business would be adversely affected.

We have an OEM Distribution Agreement (ODA) with Microsoft, which enables us to resell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico. Software sales under this agreement constitute a significant portion of our revenue. If the ODA was terminated, our software revenue and resulting gross profit would decrease significantly and our operating results would be impacted accordingly. Moreover, if the ODA with Microsoft is renewed on less favorable terms, our revenue could decrease, and/or our gross profit from these transactions, which is relatively low, could further decline. Microsoft offers us, and our competitors, largely volume-based rebates under the ODA and its related programs which have the effect of increasing our software gross profit. If Microsoft were to reduce, or eliminate, these rebate programs, which can contribute 2-3% of our total gross profit percentage from sales of Microsoft Embedded operating systems on a quarterly basis, our gross profit and operating results would be negatively impacted. The ODA is renewable annually, and there is no automatic renewal provision in the agreement. The ODA was last renewed in October 2006 and will expire on September 30, 2007, unless terminated earlier under the provisions of the ODA.

Microsoft has audited our records under our OEM Distribution Agreement in the past and may do so again in the future, and any future audit could result in additional charges.

There are provisions in the ODA that require us to maintain certain internal records and processes for royalty auditing and other reasons. Non-compliance with these and other requirements could result in the termination of the ODA. We underwent an audit under the ODA with Microsoft which began in the fourth quarter of 2003 and concluded in the second quarter of 2004. The audit covered a period of five years. Microsoft determined that we had correctly reported royalties during the audit period but that we could not account for all license inventory that we had received from Microsoft s authorized replicators. While we believe that the unaccounted-for license inventory related to undocumented inventory returns and disagreed with the audit findings, we ultimately chose to settle the dispute. Total settlement costs of $310,000 were recognized in the second quarter of 2004, which included audit costs of $140,000. It is possible that future audits could result in additional charges.

The market for the resale of Microsoft Embedded operating systems licenses is highly competitive and the profit margin on such sales is relatively low. If the profit margins in this business erode or we lose customers to competitors, our results will be negatively impacted.

There are two competitors that also resell Embedded Windows licenses to substantially the same customer base as we do in North America, which can lead to intense competition. Additionally, this competition can create additional downward pressure on gross profit margins. The gross profit margin on sales of Microsoft Embedded Windows licenses is relatively low, historically about 14% on average. There can be no assurance that gross profit on future sales will not decline given these competitive pressures.

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If we do not maintain our favorable relationship with Microsoft, we will have difficulty marketing and selling our software and services and may not receive developer releases of Windows Embedded operating systems and Windows Mobile targeted platforms. As a result, our revenue and operating results could suffer.

We maintain a strategic marketing relationship with Microsoft. In the event that our relationship with Microsoft were to deteriorate, our efforts to market and sell our software and services to OEMs and others could be adversely affected and our business could be harmed. Microsoft has significant influence over the development plans and buying decisions of OEMs and others utilizing Windows Embedded operating systems and Windows Mobile targeted platforms for smart devices and these targeted platforms are a significant focus for us. Microsoft provides customers referrals to us. Moreover, Microsoft controls the marketing campaigns related to its operating systems. Microsoft s marketing activities, including trade shows, direct mail campaigns and print advertising, are important to the continued promotion and market acceptance of Windows Embedded operating systems and Windows Mobile targeted platforms and, consequently, to our sale of Windows-based embedded software and services. We must maintain a favorable relationship with Microsoft to continue to participate in joint marketing activities with them, which includes participating in partner pavilions at trade shows, listing our services on Microsoft s website, and receiving customer referrals. In the event that we are unable to continue our joint marketing efforts with Microsoft, or fail to receive referrals from them, we would be required to devote significant additional resources and incur additional expenses to market software products and services directly to potential customers. In addition, we depend on Microsoft for developer releases of new versions of, and upgrades to, Windows Embedded and Windows Mobile software in order to facilitate timely development and delivery of our own software and services. If we are unable to maintain our favorable relationship with Microsoft, our revenue could decline and/or our costs could increase thereby negatively impacting our operating results.

Unexpected delays or announcement of delays by Microsoft of Windows Embedded operating systems and Windows Mobile targeted platforms product releases could adversely affect our revenue.

Unexpected delays or announcement of delays in Microsoft s delivery schedule for new versions of its Windows Embedded operating systems and Windows Mobile targeted platforms could cause us to delay our product introductions or impede our ability to sell our products and services and/or to complete customer projects on a timely basis. These delays, or announcements of delays by Microsoft could also cause our customers to delay or cancel their project development activities or product introductions, which may have a negative impact on our revenue and operating results.

Our marketplace is extremely competitive, which may result in price reductions, lower gross profit margins and loss of market share.

The market for Windows-based embedded software and services is extremely competitive. Increased competition may result in price reductions, lower gross profit margin and loss of customers and market share, which would harm our business. We face competition from:

- Our current and potential customers internal research and development departments, which may seek to develop their own proprietary products and solutions that compete with our proprietary software products and engineering services;
- North American engineering service firms such as Intrinsyc, CalAmp, Vanteon and Teleca;
- Off-shore development companies such as WiPro, particularly those focused on the North American marketplace;
- ODMs, particularly those in Taiwan who are adding software development capabilities to their offerings;
- Contract manufacturers who are adding software development capabilities to their offerings; and

Microsoft Embedded operating system distributors such as Arrow and Avnet. Larger customers of Microsoft Embedded operating systems are typically knowledgeable of the competing distributors in the North American market and, consequently, will often put large orders out to bid amongst the distributors, which can create margin pressure and make it difficult to maintain long-term relationships with customers who purchase only Microsoft Embedded operating systems from us.

As we develop new products, particularly products focused on specific industries, we may begin competing with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share. Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced product and service revenue opportunities for us. The barrier to entering the market as a provider of Windows-based smart device software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded operating system products and services. These systems integrators are given substantially the same access by Microsoft to the Windows technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the Windows-based smart device market, and as new products and technologies are introduced.

Microsoft has released Windows CE version 6.0 and version 5.0 of its Windows Mobile Smartphone and PocketPC operating systems which contain basic SDIO functionality. Current and potential customers may decide that the functionality they receive directly from Microsoft is sufficient to complete their device development and may therefore choose not to purchase our SDIO Now! product or delay the purchase of our SDIO Now! product while they perform a comparison of the competing products.

An agreement with Microsoft required us to deliver to Microsoft our SDIO Now! v.1.0 source code for inclusion into Windows CE 5.0 and the Windows Mobile Smartphone 5.0 and PocketPC 5.0 operating systems. Since that source code was delivered to Microsoft, we have continued to develop our SDIO Now! product line, introducing SDIO Now! v.2.0, v.2.2 and most recently SDIO Now! Hx, with new features and performance improvements that we believe are important to customers. Additionally, we plan further enhancements to our SDIO Now! software product in 2006 and beyond. However, there can be no assurance that our next-generation SDIO Now! product offerings will continue to be competitive in the marketplace or that customers will not decide to use the basic functionality they receive from Microsoft as part of the operating system. Because SDIO Now! has traditionally represented the majority of our high-margin proprietary software revenue, if customers were to decide the basic SDIO functionality provided by Microsoft was sufficient for their needs or delayed purchase or our SDIO Now! product, our proprietary software revenue and operating results would be adversely impacted.

If Microsoft adds features to its Windows operating system or develops products that directly compete with products and services we provide, our revenue and operating results could suffer.

As the developer of Windows, Windows XP Embedded, Windows CE, Windows Mobile for Smartphone and Windows Mobile for PocketPC, Microsoft could add features to its operating systems or could develop products that directly compete with the products and services we provide to our customers (e.g. SDIO Now!). The ability of our customers, or potential customers, to obtain products and services directly from Microsoft that compete with our products and services could negatively affect our revenue and operating results. Even if the standard features of future Microsoft operating system software were more limited than our offerings, a significant number of our customers, and potential customers, might elect to accept more limited functionality in lieu of purchasing additional software from us. Moreover, the resulting competitive pressures could lead to price reductions for our products and reduce our revenue and gross profit margin accordingly and our operating results could be adversely impacted.

Our ability to maintain or grow the portion of our software revenue attributable to our own proprietary software products is contingent on our ability to bring to market competitive, unique offerings that keep pace with technological changes and needs. If we are not successful in doing so, our business would be harmed.

Proprietary software product sales provide us with much higher gross profit margins than we typically receive from third-party software products and our engineering service offerings as well as other advantages. Increasing the number and amount of proprietary products we sell is an important part of our growth strategy. Our ability to maintain and increase the revenue contribution from proprietary software products is contingent on our ability to enhance the features and functionality of our current proprietary products as well as to devise, develop and introduce new products. There can be no assurance that we will be able to maintain and expand the number of proprietary products that we sell, and our failure to do so could negatively impact revenue and our operating results.

We may experience delays in our efforts to develop new products and services, and these delays could cause us to miss market opportunities which could negatively impact our revenue and operating results.

The market for Windows-based embedded software and services is very competitive. As a result, the life cycles of our products and services are difficult to estimate. To be successful, we believe we must continue to enhance our current offerings and provide new software product and service offerings with attractive features, prices and terms that appeal to our customers. We have experienced delays in enhancements and new product release dates in the past and may be unable to introduce enhancements or new products successfully or in a timely manner in the future. Our revenue and operating results may be negatively impacted if we delay releases of our products and product enhancements, or if we fail to accurately anticipate our customers needs or technical trends and are unable to introduce new products and service offerings into the market successfully. In addition, our customers may defer or forego purchases of our products if we, Microsoft, our competitors or major hardware, systems or software vendors introduce or announce new products.

If the market for smart devices develops more slowly than we expect, or declines, our revenue may not develop as anticipated, if at all, and our business would be harmed.

The market for smart devices is still emerging and the potential size of this market and the timing of its development are not known. As a result, our profit potential is uncertain and our revenue may not develop as anticipated, if at all. We are dependent upon the broad acceptance by businesses and consumers of a wide variety of smart devices, which will depend on many factors, including:

The development of content and applications for smart devices;

The willingness of large numbers of businesses and consumers to use devices such as smartphones, PDAs and handheld industrial data collectors to perform functions historically carried out manually, or by traditional PCs, including inputting and sharing data, communicating among users and connecting to the Internet; and

The evolution of industry standards or the necessary infrastructure that facilitate the distribution of content over the Internet to these devices via wired and wireless telecommunications systems, satellite or cable.

If the market for Windows Embedded operating systems and Windows Mobile targeted platforms fails to develop further, develops more slowly than expected, or declines, our business and operating results may be materially harmed.

Because a significant portion of our revenue to date has been generated by software products and engineering services targeted at the Windows Embedded operating systems and Windows Mobile platforms, if the market for these systems or platforms fails to develop further or develops more slowly than expected, or declines, our business and operating results could be negatively impacted. Market acceptance of Windows Embedded and Windows Mobile will depend on many factors, including:

Microsoft s development and support of the Windows Embedded and Windows Mobile markets. As the developer and primary promoter of Windows CE, Windows XP Embedded, Windows Mobile for Smartphone and Windows Mobile for PocketPC, if Microsoft were to decide to discontinue or lessen its support of these operating systems and platforms, potential customers could select competing operating systems, which could reduce the demand for our Windows Embedded and Windows Mobile software products and engineering services which is our primary focus today;

The ability of the Microsoft Windows Embedded operating systems and Windows Mobile software to compete against existing and emerging operating systems for the smart device market, including: VxWorks and pSOS from WindRiver Systems Inc.; Symbian and Palm OS from PalmSource, Inc.; JavaOS from Sun Microsystems, Inc.; and other proprietary operating systems. In particular, in the market for handheld devices, Windows Mobile software for Pocket PC and Windows CE face intense competition from the Linux operating system. In the market for converged devices, Windows Mobile for Pocket PC Phone Edition and for Smartphone face intense competition from the EPOC operating system from Symbian. Windows Embedded operating systems and the Windows Mobile for Smartphone may be unsuccessful in capturing a significant share of these two segments of the smart device market, or in maintaining its market share therein;

The acceptance by OEMs and consumers of the mix of features and functions offered by Windows Embedded operating systems and Windows Mobile targeted platforms; and

The willingness of software developers to continue to develop and expand the applications that run on Windows Embedded operating systems and Windows Mobile targeted platforms. To the extent that software developers write applications for competing operating systems that are more attractive to smart device users than those available on Windows Embedded operating systems and Windows Mobile targeted platforms, potential purchasers could select competing operating systems over Windows Embedded operating systems and Windows Mobile targeted platforms.

The success and profitability of our engineering service offerings are contingent on our ability to differentiate our offerings adequately in the marketplace, which is, in turn, contingent on our ability to retain our engineering personnel and defend our billing rate structure against those of our competitors, including those using lower-cost offshore resources. If we are unable to do so successfully, our business could be harmed.

We are a leader in providing engineering services to smart device customers. Our market differentiation is created through several factors, including our experience with a variety of smart device platforms and applications. Our differentiation is contingent, in part, on our ability to attract and retain employees with this expertise, significantly all of whom currently are based in the United States. To the extent we are unable to retain critical engineering services talent and/or our competition is able to deliver the same services by using lower-cost offshore resources, our service revenue and operating results could be negatively impacted.

The success and profitability of our service engagements are contingent upon our ability to scope and bid engagements and deliver our services profitably. If we are unable to do so, our service revenue service gross profit margin and operating results could be negatively impacted.

Various factors may cause the total cost of service projects to exceed the original estimate provided to the customer or the contractual maximum in the case of fixed price contracts, including specification changes, customer deliverable delays, inadequate scoping and inefficient service delivery. If we are unable to adequately scope, bid and deliver on service engagements successfully, our service revenue, service gross profit and operating results could be negatively impacted. In addition, depending on the cause of an overrun for a given customer, we may also decide to provide pricing concessions to that customer which could negatively impact our service revenue, service gross profit and operating results.

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We have entered into engineering service agreements where we have agreed to perform our engineering service work at relatively low rates per hour in exchange for royalties, sometimes guaranteed, in the future. There is no guarantee that these arrangements will culminate as anticipated.

We have entered into service contracts that involve reducing up-front engineering service fees in return for a per-device royalty as our customers ship their devices, and we may enter into more such agreements in the future. These contracts call for guaranteed royalty payments by our customers. Because we are delaying revenue past the point where our services are performed, there is a risk that our customers may cancel their device projects or that their devices may not be successful in the market. In addition, these customers may not to pay us all royalties owed, which could negatively impact our revenue and operating results.

Cooperation and support from Silicon Vendors is critical for the success of our Hardware Reference designs. Such cooperation cannot be guaranteed.

We have recently been developing hardware reference designs based on the Intel PXA Xscale architecture and plan to develop reference designs based on other silicon architectures. It is important that the silicon on which we base our reference designs receive continued support in the market place by the Silicon Vendor. For example, during the development of our designs, Intel made a strategic decision to sell its PXA Xscale division to Marvell which had negatively impacted the sale of our Xscale-based reference designs. There can be no guarantee that Marvell will continue to pursue and support the markets that we have been targeting with our reference designs. Cooperation and support from SVs is critical to the success of our reference designs, and should the SVs not support our efforts, our revenue and operating results could be negatively impacted.

If we are unable to license key software from third parties, our business could be harmed.

We sometimes integrate third-party software with our proprietary software and engineering service offerings or sell such third-party software offerings on a standalone basis (e.g. embedded operating systems under our ODA with Microsoft). If our relationships with these third-party software vendors were to deteriorate, or be eliminated in their entirety, we might be unable to obtain licenses on commercially reasonable terms, if at all. In the event that we are unable to obtain these third-party software offerings, we would be required to develop this technology internally, assuming it was economically or technically feasible, or seek similar software offerings from other third parties assuming there were competing offerings in the marketplace, which could delay or limit our ability to introduce enhancements or new products, or to continue to sell existing products and engineering services, thereby negatively impacting our revenue and operating results.

Our revenue may flatten or decline and we may not be able to regain and sustain profitability in accordance with our current plans.

We have generated net losses in every year since 2001. If our revenue remains flat or declines and/or our expenses increase or cannot be maintained proportionately, we will experience additional losses and will be required to use our existing cash to fund operations. We expect that our expenses will continue to be substantial in the foreseeable future, including compliance costs associated with the Sarbanes-Oxley Act of 2002, and may prove higher than we currently anticipate. Further, we may not succeed in increasing our revenue sufficiently to offset unanticipated expense increases.

Unexpected fluctuations in our operating results could cause our stock price to decline.

Our operating results have fluctuated in the past, and we expect that they will continue to do so. If our operating results fall below the expectations of analysts and investors, the price of our common stock may fall. Factors that have in the past and may continue in the future to cause our operating results to fluctuate include those described in this Risk Factors section. In addition, our stock price may fluctuate due to conditions unrelated to our operating performance, including general economic conditions in the technology industry, our Nasdaq listing status and the market for technology stocks.

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A continued decline in our shareholders equity or a decline in our stock price could cause our common stock to be delisted from the Nasdaq National Market.

As of September 30, 2006, our shareholders equity was $10.9 million. The minimum continued listing requirement for the Nasdaq National Market is $10.0 million. We have incurred significant net losses since 2001 and may incur additional losses in the future. If our shareholders equity decreases below $10 million, we will be notified by the Nasdaq Listing Qualifications Department that we are not in compliance with the minimum $10 million shareholders equity requirement of Nasdaq Marketplace Rule 4450(a)(3). In addition, during the last three years, our common stock has traded at times near or below the $1.00 Nasdaq National Market minimum bid price.

If we fail to maintain compliance with Nasdaq listing requirements and our common stock is ultimately delisted from trading on the Nasdaq National Market as a result of listing requirement violations and is neither relisted thereon nor listed for trading on the Nasdaq Capital Market, trading in our common stock may continue to be conducted on the OTC Bulletin Board or in a non-Nasdaq over-the-counter market, such as the pink sheets. Delisting of our common stock from trading on the Nasdaq National or Capital Market would adversely affect the price and liquidity of our common stock and could adversely affect our ability to issue additional securities or to secure additional financing. In that event our common stock could also be deemed to be a penny stock under the Securities Enforcement and Penny Stock Reform Act of 1990, which would require additional disclosure in connection with trades in the common stock, including the delivery of a disclosure schedule explaining the nature and risks of the penny stock market. Such requirements could further adversely affect the liquidity of our common stock.

Non-compliance with certain agreements could have a material adverse impact on our financial position.

In addition to our Microsoft OEM Distribution Agreement described previously, if we default under our corporate headquarters lease, the landlord has the ability to demand cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord has the ability to demand repayment, in the event of default, decreases on the straight-line basis over the length of our ten-year headquarters lease. The total amount of cash payments forgiven for which the landlord has the ability to demand repayment was $1.9 million at September 30, 2006. Any breach of or non-compliance with these lease agreements or our OEM Distribution Agreement with Microsoft could have a material adverse impact on our business.

The long sales cycle of our products and services makes our revenue susceptible to fluctuations.

Our sales cycle is typically three to nine months because the expense and complexity of the software and engineering service offerings we sell generally require a lengthy customer approval process and may be subject to a number of significant risks over which we have little or no control, including:

Customers budgetary constraints and internal acceptance review procedures;

The timing of budget cycles; and

The timing of customers competitive evaluation processes.

In addition, to successfully sell software and engineering service offerings, we must frequently educate our potential customers about the full benefits of these software and services, which can require significant time. If our sales cycle further lengthens unexpectedly, it could adversely affect the timing of our revenue which could cause our quarterly results to fluctuate.

Erosion of the financial condition of our customers could adversely affect our business.

Our business could be adversely affected should the financial condition of our customers erode, given that such erosion could reduce demand from those customers for our software and engineering services, could cause them to terminate their relationships with us, and/or could increase the credit risk of those customers. If the global

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information technology market weakens, the likelihood of the erosion of the financial condition of our customers increases, which could adversely affect the demand for our software and services. Additionally, while we believe that our allowance for doubtful accounts is adequate, those allowances may not cover actual losses, which could adversely affect our business and operating results.

Continued erosion of our financial condition would adversely affect our business.

If our financial condition continues to erode, particularly if we continue to generate operating losses and our cash balance declines, our customers and potential customers may decide that our financial condition is not sufficient to do business with us, particularly those that have implemented new vendor requirements as part of their Sarbanes-Oxley compliance, and may choose to engage with one of our competitors. Customers choosing not to do business with us as a result of our financial condition could adversely affect our business and operating results.

Our software and service offerings could infringe the intellectual property rights of third parties, which could expose us to additional costs and litigation and could adversely affect our ability to sell our products and services or cause shipment delays or stoppages.

It is difficult to determine whether our products and engineering services infringe third-party intellectual property rights, particularly in a rapidly evolving technological environment in which technologies often overlap and where there may be numerous patent applications pending, many of which are confidential when filed. If we were to discover that one of our products or service offerings, or a product based on one of our reference designs, violated a third-party s proprietary rights, we may not be able to obtain a license on commercially reasonable terms, or at all, to continue offering that product or service. Similarly, third parties may claim that our current or future products and services infringe their proprietary rights, regardless of whether such claims have merit. Any such claims could increase our costs and negatively impact our business and operating results. In certain cases, we have been unable to obtain indemnification against claims that our products and services infringe the proprietary rights of others. However, any indemnification we do obtain may be limited in scope or amount. Even if we receive broad third-party indemnification, these entities may not have the financial capability to indemnify us in the event of infringement. In addition, in some circumstances we could be required to indemnify our customers for claims made against them that are based on our products or services. There can be no assurance that infringement or invalidity claims related to the products and services we provide, or arising from the incorporation by us of third-party technology, and claims for indemnification from our customers resulting from such claims, will not be asserted or prosecuted against us. Some of our competitors have, or are affiliated, with companies with substantially greater resources than we have, and these competitors may be able to sustain the costs of complex intellectual property litigation to a greater degree and for longer periods of time than we could. In addition, we expect that software developers will be increasingly subject to infringement claims as the number of products and competitors in the software industry grows, and as the functionality of products in different industry segments increasingly overlap. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources in addition to potential product redevelopment costs and delays. Furthermore, if we were unsuccessful in resolving a patent or other intellectual property infringement action claim against us, we may be prohibited from developing or commercializing certain of our technologies and products, or delivering services based on the infringing technology, unless we obtain a license from the holder of the patent or other intellectual property rights. There can be no assurance that we would be able to obtain any such license on commercially favorable terms, or at all. If such license is not obtained, we would be required to cease these related business operations, which could have a material adverse effect on our business, revenue and operating results.

If we fail to adequately protect our intellectual property rights, competitors may be able to use our technology or trademarks, which could weaken our competitive position, reduce our revenue and increase our costs.

If we fail to adequately protect our intellectual property, our competitive position could be weakened and our revenue adversely affected. We rely primarily on a combination of patent, copyright, trade secret and trademark laws, as well as confidentiality procedures and contractual provisions, to protect our intellectual property. These laws and procedures provide only limited protection. We have applied for a number of patents relating to our engineering work although we do not rely on patents as our primary defensive measure in protecting our intellectual property. These patents, both issued and pending, may not provide sufficiently broad protection, or they may not prove to be enforceable, against alleged infringers. There can be no assurance that any of our pending patents will be granted. Even if granted, these patents may be circumvented or challenged and, if challenged, may be invalidated. Any patents obtained may provide limited or no competitive advantage to us. It is also possible that another party could obtain patents that block our use of some, or all, of our products and services. If that occurred, we would need to obtain a license from the patent holder or design around those patents. The patent holder may or may not choose to make a license available to us at all or on acceptable terms. Similarly, it may not be possible to design around a blocking patent. In general, there can be no assurance that our efforts to protect our intellectual property rights through patent, copyright, trade secret and trademark laws will be effective to prevent misappropriation of our technology, or to prevent the development and design by others of products or technologies similar to or competitive with those developed by us.

We frequently license the source code of our products and the source code results of our services to customers. There can be no assurance that customers with access to our source code will comply with the license terms or that we will discover any violations of the license terms or, in the event of discovery of violations, that we will be able to successfully enforce the license terms and/or recover the economic value lost from such violations. To license some of our software products, we rely in part on shrinkwrap and clickwrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. As with other software, our products are susceptible to unauthorized copying and uses that may go undetected, and policing such unauthorized use is difficult. A significant portion of our marks include the word BSQUARE or the preface b. Other companies use forms of BSQUARE or the preface b in their marks alone, or in combination with other words, and we cannot prevent all such third-party uses. We license certain trademark rights to third parties. Such licensees may not abide by our compliance and quality control guidelines with respect to such trademark rights and may take actions that would harm our business.

The computer software market is characterized by frequent and substantial intellectual property litigation, which is often complex and expensive, and involves a significant diversion of resources and uncertainty of outcome. Litigation may be necessary in the future to enforce our intellectual property or to defend against a claim of infringement or invalidity. Litigation could result in substantial costs and the diversion of resources and could negatively impact our business and operating results.

We may be subject to product liability claims that could result in significant costs.

Our license, warranty and service agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that these provisions may be ineffective under the laws of certain jurisdictions. Although we have not experienced any product liability claims to date, the sale and support of our products and services may be subject to such claims in the future. In addition, to the extent we develop and sell increasingly comprehensive, customized turnkey solutions for our customers, we may be increasingly subject to risks of product liability claims. There is a risk that any such claims or liabilities may exceed, or fall outside, the scope of our insurance coverage, and we may be unable to retain adequate liability insurance in the future. A product liability claim brought against us, whether successful or not, could harm our business and operating results.

Our software or hardware products or the third-party hardware or software integrated with our products may suffer from defects or errors that could impair our ability to sell our products and services.

Software and hardware components as complex as those needed for smart devices frequently contain errors or defects, especially when first introduced or when new versions are released. We have had to delay commercial release of certain versions of our products until problems were corrected and, in some cases, have provided product enhancements to correct errors in released products. Some of our contracts require us to repair or replace products that fail to work. To the extent that we repair or replace products our expenses may increase. In addition, it is possible that by the time defects are fixed, the market opportunity may decline which may result in lost revenue. Moreover, to the extent that we provide increasingly comprehensive products and services, particularly those focused on hardware, and rely on third-party manufacturers and suppliers to manufacture these products, we will be dependent on the ability of third-party manufacturers to correct, identify and prevent manufacturing errors. Errors that are discovered after commercial release could result in loss of revenue or delay in market acceptance, diversion of development resources, damage to our reputation and increased service and warranty costs, all of which could negatively affect our business and operating results.

As we increase the amount of software development conducted in non-U.S. locations, potential delays and quality issues may impact our ability to timely deliver our software and services, potentially impacting our revenue and profitability.

We conduct development activities in non-U.S. locations, primarily India and Taiwan, to take advantage of the high-quality, low-cost software development resources found in these countries. Additionally, we have plans to increase development activity in both our Taiwan operation and other non-U.S. locations as engineering demands necessitate the hiring of additional engineering personnel. To date, we have limited experience in managing large scale software development done in non-U.S. locations. Moving portions of our software development to these locations inherently increases the complexity of managing these programs and may result in delays in introducing new products to market, or delays in completing service projects for our customers, which in turn may adversely impact the revenue we recognize from related products and services and could also adversely impact the profitability of service engagements employing off-shore resources.

As our customers seek more cost-effective locations to develop and manufacture their smart devices, particularly overseas locations, our ability to continue to sell these customers our products and services could be limited, which could negatively impact our revenue and operating results.

Due to competitive and other pressures, some of our customers have and others may seek to move the development and manufacturing of their smart devices to overseas locations which may limit our ability to sell these customers our products and services. As an example, under our OEM Distribution Agreement with Microsoft, we are only able to resell Microsoft Embedded operating systems largely in North America. If our customers, or potential customers, move their manufacturing overseas we may be restricted from reselling these customers Microsoft Embedded operating systems, or our other products and services, which could negatively impact our revenue and operating results.

Past acquisitions have proven difficult to integrate, and future acquisitions, if any, could disrupt our business, dilute shareholder value and adversely affect our operating results.

We have acquired the technologies, assets and/or operations of other companies in the past and may acquire or make investments in companies, products, services and technologies in the future as part of our growth strategy. As an example, on June 30, 2005, we acquired certain assets of Vibren Technologies, Inc. for $500,000 in cash and the assumption of certain liabilities and obligations. If we fail to properly evaluate, integrate and execute on our acquisitions and investments, our business and prospects may be seriously harmed. In some cases, we have implemented reductions in workforce and office closures in connection with an acquisition, which has resulted in significant costs to us. To successfully complete an acquisition, we must properly evaluate the technology, accurately forecast the financial impact of the transaction, including accounting charges and transaction expenses, integrate and retain personnel, combine potentially different corporate cultures and effectively integrate products and research and development, sales, marketing and support operations. If we fail to do any of these, we may suffer losses and impair relationships with our employees, customers and strategic partners. Additionally, management may be distracted from day-to-day operations. We also may be unable to maintain uniform standards, controls, procedures and policies, which are especially critical in light of the new Sarbanes-Oxley compliance requirements, and significant demands may be placed on our management and our operations, information services and financial, legal and marketing resources. Finally, acquired businesses sometimes result in unexpected liabilities and contingencies, which could be significant.

It might be difficult for a third-party to acquire us even if doing so would be beneficial to our shareholders.

Certain provisions of our articles of incorporation, bylaws and Washington law may discourage, delay or prevent a change in the control of us or a change in our management, even if doing so would be beneficial to our shareholders. Our Board of Directors has the authority under our amended and restated articles of incorporation to issue preferred stock with rights superior to the rights of the holders of common stock. As a result, preferred stock could be issued quickly and easily with terms calculated to delay or prevent a change in control of our company or make removal of our management more difficult. In addition, our Board of Directors is divided into three classes. The directors in each class serve for three-year terms, one class being elected each year by our shareholders. This system of electing and removing directors may discourage a third-party from making a tender offer or otherwise attempting to obtain control of our company because it generally makes it more difficult for shareholders to replace a majority of our directors. In addition, Chapter 19 of the Washington Business Corporation Act generally prohibits a target corporation from engaging in certain significant business transactions with a defined acquiring person for a period of five years after the acquisition, unless the transaction or acquisition of shares is approved by a majority of the members of the target corporation s Board of Directors prior to the time of acquisition. This provision may have the effect of delaying, deterring or preventing a change in control of our company. The existence of these anti-takeover provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

We likely will incur substantial costs to comply with the requirements of the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act of 2002 (the Act) introduced new requirements regarding corporate governance and financial reporting. Among the many requirements is the requirement under Section 404 of the Act for management to annually assess and report on the effectiveness of our internal control over financial reporting and for our registered public accountant to attest to this report. The SEC has modified the effective date of Section 404 implementation for non-accelerated filers, such as us, such that we are required to issue our report on internal control over financial reporting as of December 31, 2007. We will be required to dedicate significant time and resources during fiscal 2006 and 2007 to ensure compliance. The costs to comply with these requirements will likely be significant and adversely affect our operating results. In addition, there can be no assurance that we will be successful in our efforts to comply with Section 404. Failure to do so could result in penalties and additional expenditures to meet the requirements, which could affect the ability of our auditors to issue an unqualified report which, in turn, may further adversely affect our business.

Decreased effectiveness of equity compensation could adversely affect our ability to attract and retain employees, and required changes in accounting for equity compensation could adversely affect earnings.

We have historically used stock options and other forms of equity-related compensation as key components of our overall employee compensation program in order to align employees interests with the interests of our shareholders, encourage employee retention, and provide competitive compensation packages. Applicable stock exchange listing standards relating to obtaining shareholder approval of equity compensation plans could make it more difficult or expensive for us to grant options or new forms of equity instruments to employees in the future. As a result, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, any of which could materially adversely affect our business.

Our international operations expose us to greater intellectual property, management, collections, regulatory and other risks.

Customers outside of North America generated approximately 6% of our total revenue for the nine months ended September 30, 2006. We currently have international operations in Taipei, Taiwan, Vancouver and Tokyo, Japan. Our international activities and operations expose us to a number of risks, including the following:

- Greater difficulty in protecting intellectual property due to less stringent foreign intellectual property laws and enforcement policies;

- Longer collection cycles than we typically experience in the North America;

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Unfavorable changes in regulatory practices and tariffs;

Complex and/or adverse tax laws and/or changes thereto. Additionally, we may be subject to income, withholding and other taxes for which we may realize no current benefit despite the existence of significant net operating losses and tax credits in the U.S.;

Loss or reduction of withholding tax exemptions;

The impact of fluctuating exchange rates between the U.S. dollar and foreign currencies; and

General economic and political conditions in international markets which may differ from those in the U.S. These risks could have a material adverse effect on the financial and managerial resources required to operate our foreign offices, as well as on our future international revenue, which could harm our business and operating results.

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Item 6. Exhibits

Exhibit No.	Exhibit Description
3.1	Amended and Restated Articles of Incorporation (incorporated by reference to our registration statement on Form S-1 (File No. 333-85351) filed with the Securities and Exchange Commission on October 19, 1999)
3.1(a)	Articles of Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our quarterly report on Form 10-Q filed with the Securities and Exchange Commission on August 7, 2000)
3.1(b)	Articles of Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our current report on Form 8-K filed with the Securities and Exchange Commission on October 11, 2005)
3.2	Bylaws and all amendments thereto (incorporated by reference to our annual report on Form 10-K filed with the Securities and Exchange Commission on March 19, 2003)
10.18*+	OEM Distribution Agreement for Software Products for Embedded Systems between BSQUARE Corporation and Microsoft Licensing, GP, dated as of October 1, 2006.
31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

* Replaces previously filed exhibit.

\+ Confidential portions omitted and filed separately with the SEC pursuant to request for confidential treatment.

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: November 9, 2006		
	By:	/s/ Brian T. Crowley
		Brian T. Crowley *President and Chief Executive Officer*
Date: November 9, 2006		
	By:	/s/ Scott C. Mahan
		Scott C. Mahan *Vice President of Finance and* *Chief Financial Officer*

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BSQUARE CORPORATION
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