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

---

# FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2000

OR

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

For the Transition Period from __________ to ____________ .

Commission File Number: 000-27687

---

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

| | |
|---|---|
| WASHINGTON | 91-1650880 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 3150 139TH AVENUE SE, SUITE 500, BELLEVUE WA | 98005 |
| (Address of principal executive offices) | (Zip Code) |

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

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

As of May 2, 2000, there were 32,625,346 shares of the registrant's common stock outstanding.

BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended March 31, 2000

TABLE OF CONTENTS


| | | PAGE |
|---|---|---|
| PART I. FINANCIAL INFORMATION | | |
| Item 1. | Condensed Consolidated Financial Statements | 3 |
| | Condensed Consolidated Balance Sheets - | 3 |
| | Condensed Consolidated Statements of Income - | 4 |
| | Condensed Consolidated Statements of Cash Flows - | 5 |
| | Notes to Condensed Consolidated Financial Statements | 6 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 7 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 18 |
| PART II. | OTHER INFORMATION | |
| Item 2. | Changes in Securities and Use of Proceeds | 19 |
| Item 4. | Submission of Matters to a Vote of Security Holders. | 19 |
| Item 6. | Exhibits and Reports on Form 8-K | 20 |

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

BSQUARE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

| | March 31, 2000 (unaudited) | December 31, 1999 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 59,358 | $ 55,604 |
| Short-term investments | 26,869 | 27,368 |
| Accounts receivable, net | 6,491 | 4,302 |
| Prepaid expenses and other current assets | 579 | 609 |
| Total current assets | 93,297 | 87,883 |
| Furniture, equipment and leasehold improvements, net | 5,693 | 7,239 |
| Deposits and other assets | 1,422 | 211 |
| Total assets | $ 100,412 | $ 95,333 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 306 | $ 653 |
| Accrued expenses | 4,921 | 4,424 |
| Deferred revenue | 4,269 | 1,130 |
| Total current liabilities | 9,496 | 6,207 |
| Shareholders' equity: | | |
| Blue Water Systems, Inc. Series A Preferred stock, no par value: authorized 500,000 shares, issued and no shares outstanding in 2000 and 15,151 shares outstanding in 1999 | -- | 250 |
| Common stock, no par value: authorized 50,000,000 shares, issued and outstanding, 32,592,108 shares in 2000 and 32,556,224 in 1999 | 91,722 | 90,827 |
| Deferred stock option compensation | (697) | (868) |
| Cumulative foreign currency translation adjustment | (36) | (15) |
| Accumulated deficit | (73) | (1,068) |
| Total shareholders' equity | 90,916 | 89,126 |
| Total liabilities and shareholders' equity | $ 100,412 | $ 95,333 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)

| | Three Months Ended March 31, 2000 | 1999 |
|---|---|---|
| | (unaudited) | |
| Revenue: | | |
| Service | $ 12,284 | $ 8,562 |
| Product | 1,008 | 605 |
| Total revenue | 13,292 | 9,167 |
| Cost of revenue: | | |
| Service | 6,197 | 4,108 |
| Product | 152 | 77 |
| Total cost of revenue | 6,349 | 4,185 |
| Gross profit | 6,943 | 4,982 |
| Operating expenses: | | |
| Research and development | 2,044 | 1,643 |
| Selling, general and administrative | 3,520 | 2,502 |
| Amortization of deferred stock option compensation | 171 | 118 |
| Total operating expenses | 5,735 | 4,263 |
| Income from operations | 1,208 | 719 |
| Other income (expense) net: | | |
| Interest income, net | 826 | 54 |
| Acquisition related expenses | (620) | -- |
| Income before income taxes | 1,414 | 773 |
| Provision for income taxes | 419 | 344 |
| Net income | $ 995 | $ 429 |
| Basic earnings per share | $ 0.03 | $ 0.02 |
| Weighted average shares outstanding used to compute basic earnings per share | 32,566 | 18,458 |
| Diluted earnings per share | $ 0.03 | $ 0.02 |
| Weighted average shares outstanding to compute diluted earnings per share | 35,628 | 28,468 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended March 31, 2000 | Three Months Ended March 31, 1999 |
|---|---|---|
| | (unaudited) | |
| Cash flows from operating activities: | | |
| Net income | $ 995 | $ 429 |
| Adjustments to reconcile net income to net cash provided by operating activities- | | |
| Depreciation and amortization | 604 | 546 |
| Deferred income taxes | (229) | (172) |
| Amortization of deferred stock option compensation | 171 | 118 |
| Loss on disposal of assets | 81 | -- |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2,193) | 670 |
| Prepaid expenses and other current assets | 49 | (17) |
| Deposits and other assets | 22 | (99) |
| Accounts payable and accrued expenses | 1,603 | 985 |
| Deferred revenue | 3,138 | 380 |
| Net cash provided by operating activities | 4,241 | 2,840 |
| Cash flows from investing activities: | | |
| Purchases of furniture, equipment and leasehold improvements | (343) | (559) |
| Maturity of short-term investments, net | 500 | 1,583 |
| Purchase of an investment | (1,250) | -- |
| Net cash (used in) provided by investing activities | (1,093) | 1,024 |
| Cash flows from financing activities: | | |
| Payments on long-term obligations | (6) | (51) |
| Proceeds from exercise of stock options and warrants | 644 | 2 |
| Net cash provided by (used in) financing activities | 638 | (49) |
| Effect of exchange rate changes on cash | (32) | 6 |
| Net increase in cash and cash equivalents | 3,754 | 3,821 |
| Cash and cash equivalents, beginning of period | 55,604 | 5,473 |
| Cash, and cash equivalents, end of period | $ 59,358 | $ 9,294 |

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The 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 and include the accounts of the Company. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company, the unaudited financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company's financial position at March 31, 2000, its operating results and cash flows for the three-months ended March 31, 2000 and 1999. These financial statements and the notes should be read in conjunction with the Company's financial statements and notes thereto contained in the Company's annual report on Form 10-K for the year ended December 31, 1999 (File No. 000-27687) filed with the Securities and Exchange Commission. Interim results are not necessarily indicative of results for a full year.

2. ACQUISITION OF BLUEWATER SYSTEMS, INC.

On January 5, 2000, the Company acquired BlueWater Systems, Inc. in a transaction accounted for as a pooling of interests. BlueWater Systems, formerly located in Edmonds, Washington is dedicated to the design of software development tool kits and system integration services for the creation of Windows-based intelligent computing devices. The transaction was effected through the exchange of 261,391 shares of BSQUARE common stock for all of the issued and outstanding common shares of BlueWater Systems. The consolidated financial statements of BSQUARE have been restated for all periods prior to the merger to include the accounts and operations of BlueWater Systems, Inc. In connection with the acquisition, the Company incurred $620,000 ($515,000 after taxes, or $0.01 per diluted share) of acquisition-related costs which were charged to operations during the three months ended March 31, 2000.

The following table presents a reconciliation of revenue and net income previously reported by BSQUARE to those presented in the accompanying condensed consolidated financial statements:

| | Three Months Ended March 31, 1999 (in thousands) |
|---|---|
| Revenue: | |
| BSQUARE Corporation | $ 8,809 |
| BlueWater Systems, Inc. | 358 |
| Combined | $ 9,167 |
| Net income (loss): | |
| BSQUARE Corporation | $ 432 |
| BlueWater Systems, Inc. | (3) |
| Combined | $ 429 |

3. COMPREHENSIVE INCOME

Components of comprehensive income consist of the following:

| | Three Months Ended March 31, 2000 | Three Months Ended March 31, 1999 |
|---|---|---|
| | (in thousands) | |
| Net income | $ 995 | $ 429 |
| Foreign currency translation adjustment | (21) | (13) |
| Comprehensive income | $ 974 | $ 416 |

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 may contain statements that are "forward-looking statements" involving risks and uncertainties. In particular, statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations" relating to our revenue, profitability, sufficiency of capital to meet working capital and capital expenditure requirements may be forward-looking statements. The words "expect," "anticipate," "plan," "believe," "seek," "estimate" 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 publicly 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 elsewhere in this report in the section entitled "Certain Factors That May Affect Future Results."

OVERVIEW

We are a leading provider of software solutions that enable the development and proliferation of a wide variety of intelligent computing devices based on the Microsoft Windows-based operating systems. Intelligent computing devices, or ICDs, are classes of non-personal computer devices that offer electronic connectivity. We work with semiconductor vendors and original equipment manufacturers to provide software products and engineering services for the development of intelligent computing devices.

We enable the rapid and low-cost deployment of intelligent computing devices by providing a variety of software products and services for the development, integration and deployment of Windows-powered operating systems with industry-specific applications. We also develop software applications that are licensed to end users to provide intelligent computing devices with additional functionality. Our products and services are marketed and supported on a worldwide basis through a direct sales force augmented by distributors.

To date, we have derived substantially all of our revenue from the provision of services to Microsoft, semiconductor vendors and original equipment manufacturers. We also generate product revenue from software sales and royalty licenses. We perform our services under both time-and-materials contracts and fixed-fee contracts. We also receive a small portion of service revenue from the provision of contract support services upon the purchase of our software products. We sell our packaged software products through standard retail channels, our direct sales force and through indirect channels, such as resellers. In addition, we receive royalty payments from original equipment manufacturers related to the bundling of our software on their intelligent computing devices and, more recently, from the license to them of software products contained in our intelligent computing device integration tool kits.

MICROSOFT MASTER DEVELOPMENT AND LICENSE AGREEMENT

For the three months ended March 31, 2000 and 1999, approximately 77% and 81% of our revenue, respectively, was generated under our master development and license agreement with Microsoft. We anticipate that we will continue to receive a substantial portion of our revenue from the provision of services to Microsoft. The master agreement, the current renewable term of which concludes in July 2000, includes a number of project-specific work plans. We bill Microsoft on a time-and-materials basis, although each project has a maximum dollar cap, and recognize revenue generated under the master agreement as the services are rendered. The master agreement and each of the individual work plans may be modified or terminated by Microsoft at any time. While we anticipate that our relationship with Microsoft will remain strong, we are unable to predict the magnitude and number of future projects for Microsoft.

RESULTS OF OPERATIONS

The following table presents certain financial data as a percentage of total revenue for the three-month periods ended March 31, 2000 and 1999. Our historical operating results are not necessarily indicative of the results for any future period.

| | Three Months Ended March 31, 2000 | Three Months Ended March 31, 1999 |
|---|---|---|
| Revenue: | | |
| Service | 92% | 93% |
| Product | 8 | 7 |
| Total revenue | 100 | 100 |
| Cost of revenue: | | |
| Service | 47 | 45 |
| Product | 1 | 1 |
| Total cost of revenue | 48 | 46 |
| Gross margin | 52 | 54 |
| Operating expenses: | | |
| Research and development | 15 | 18 |
| Selling, general and administrative | 27 | 27 |
| Amortization of deferred stock option compensation | 1 | 1 |
| Total operating expenses | 43 | 46 |
| Income from operations | 9 | 8 |
| Interest income (expense), net: | | |
| Interest income, net | 7 | -- |
| Merger related expenses | (5) | -- |
| Income before income taxes | 11 | 8 |
| Provision for income taxes | 3 | 3 |
| Net income | 8% | 5% |

REVENUE

Revenue consists of service and product revenue, which includes software license fees and royalties. Total revenue increased 45% to $13.3 million for the three months ended March 31, 2000, from $9.2 million for the three months ended March 31, 1999. Revenue outside of the U.S. totaled $1.2 million and $140,000 for the three months ended March 31, 2000 and 1999, respectively.

SERVICE REVENUE. Service revenue increased 43% to $12.3 million for the three months ended March 31, 2000 from $8.6 million for the three months ended March 31, 1999. This increase was due to an increase in the number and size of consulting service projects. As a percentage of total revenue, service revenue did not change materially.

PRODUCT REVENUE. Product revenue increased 67% to $1.0 million for the three months ended March 31, 2000, from $605,000 for the three months ended March 31, 1999. This increase resulted primarily from an increase in sales of platform technology products, the CE Validator quality assurance test suite, and third-party products. As a percentage of total revenue, product revenue did not change materially.

COST OF REVENUE

COST OF SERVICE REVENUE. Cost of service revenue consists primarily of salaries and benefits for software developers and quality assurance personnel, plus an allocation of facilities and depreciation costs. Cost of service revenue increased 51% to $6.2 million for the three months ended March 31, 2000, from $4.1 million for the three months ended March 31, 1999. The increase in absolute dollars resulted primarily from the hiring and training of additional employees to support an increased number of projects. At March 31, 2000 and 1999, we had approximately 251 and 188 employees, respectively, engaged in engineering consulting. Cost of service revenue as a percentage of related service revenue was 50% and 48% for the three months ended March 31, 2000 and 1999, respectively. The increase in cost of service revenue as a percentage of the related service revenue in 2000 was primarily the result of an increase in software engineering compensation due to competitive employee recruiting and retention pressures in the greater-Seattle area.

COST OF PRODUCT REVENUE. Cost of product revenue consists of license fees and royalties for third-party software, product media, product duplication and manuals. Cost of product revenue increased 99% to $152,000 for the three months ended March 31, 2000, from $77,000 for the three months ended March 31, 1999. As a percent of product revenue, cost of product sales was 15% for the three months ended March 31, 2000 and 13% for the same period in 1999. The increase in cost of product sales as a percent of related product revenue relates to an increase in sales of third-party products.

OPERATING EXPENSES

RESEARCH AND DEVELOPMENT. Research and development expenses consist primarily of salaries and benefits for software developers, quality assurance personnel, program managers plus an allocation of our facilities and depreciation costs. Research and development expenses increased 24% to $2.0 million for the three months ended March 31, 2000, from $1.6 million for the three months ended March 31, 1999. This increase resulted from an increase in the number of software developers and quality assurance personnel to expand our product offerings and to support development and testing activities. Research and development expenses represented 15% and 18% of our total revenue for the three months ended March 31, 2000 and 1999, respectively. The decrease in research and development expenses as a percentage of total revenue for the three months ended March 31, 2000 over the same period in 1999 reflects the more rapid increase of our revenue compared to the growth in research and development during this period. We anticipate that research and development expenses will continue to increase in absolute dollars in future periods as we continue to expand our market position.

SELLING, GENERAL AND ADMINISTRATIVE. Selling, general and administrative expenses increased 41% to $3.5 million for the three months ended March 31, 2000, from $2.5 million for the same period in 1999. This increase resulted primarily from our investment in finance, executive, administration, sales and marketing infrastructure, both domestically and internationally, which included significant personnel-related expenses, travel expenses and related facility and equipment costs, as well as investor relations, annual reporting and other costs associated with having become a public company. Selling, general and administrative expenses remained relatively constant at 27% of our total revenue for the both three month periods in 2000 and 1999. We anticipate that selling, general and administrative expenses will continue to increase in absolute dollars in future periods as we expand our sales and marketing staff both internationally and domestically.

AMORTIZATION OF DEFERRED STOCK OPTION COMPENSATION. We recorded amortization of deferred stock option compensation of $171,000 for the three months ended March 31, 2000 and $118,000 for the same period in 1999, resulting from stock option grants at prices below the deemed fair market value of our common stock when we were a private company. Deferred stock option compensation is amortized over the vesting periods of the options.

OTHER INCOME (EXPENSE), NET

Interest income, net consists primarily of earnings on our cash, cash equivalents and short-term investment balances offset by interest expense associated with debt obligations. Interest income, net was $826,000 for the three months ended March 31, 2000 and $54,000 for the three months ended March 31, 1999. The increase resulted from higher average cash, cash equivalent and short-term investment balances during the three-month period in 2000.

In January 2000, the Company acquired BlueWater Systems, Inc. in a transaction accounted for as a pooling of interests. In connection with the acquisition, the Company incurred $620,000 ($515,000 after taxes, or $0.01 per diluted share) of acquisition-related costs which were charged to operations during the three months ended March 31, 2000.

PROVISION FOR INCOME TAXES.

Our provision for federal, state and international income taxes was $419,000 for the three months ended March 31, 2000 as compared to $344,000 for the three months ended March 31, 1999, yielding effective rates of 30% during that period in 2000 and 45% during the same period in 1999. The decrease in the effective rate was due primarily to the tax benefit of interest income earned on tax-exempt and tax-advantaged municipal securities held in our short-term investment portfolio.

## LIQUIDITY AND CAPITAL RESOURCES

As of March 31, 2000, we had $86.2 million of cash, cash equivalents and short-term investments. This represents an increase of $3.3 million over December 31, 1999. In October 1999, we completed an initial public offering of 4,000,000 shares of common stock and raised $54.4 million, net of offering costs. Our working capital at March 31, 2000 was $83.8 million compared to $81.7 million at December 31, 1999.

Our operating activities resulted in net cash inflows of $4.2 million for the three months ended March 31, 2000 and $2.8 million for the same period in 1999. The sources of cash were primarily income from operations and increases in deferred revenue, accounts payable and accrued liabilities, partially offset by increases in accounts receivable.

Investing activities used $1.1 million for the three months ended March 31, 2000, compared to providing $1.0 million of cash for the three months ended March 31, 1999. Investing activities in 2000 included $1.3 million for purchase of an investment and $343,000 in capital equipment purchases. Investing activities in 1999 included $1.6 million maturity of short-term investments and $559,000 in capital equipment purchases.

Financing activities generated $638,000 for the three months ended March 31, 2000, primarily through the exercise of warrants by former BlueWater Systems, Inc. Series A Preferred shareholders. Financing activities used $49,000 for the same period in 1999, primarily for repayment of long-term obligations.

We have a working capital revolving line of credit with Imperial Bank that is secured by our accounts receivable. This facility allows us to borrow up to the lesser of 80% of our eligible accounts receivable or $5.0 million and bears interest at the bank's prime rate, which was 9.0% at March 22, 2000. The facility expires in July 2000. The agreement under which the line of credit was established contains certain covenants, including a provision requiring us to maintain specified financial ratios. We were in compliance with these covenants at March 31, 2000, and at that time there were no borrowings outstanding under this credit facility. We also maintain with Imperial Bank a $1.5 million term loan for equipment purchases, which bears interest at the bank's prime rate plus 0.25%, and a $4.0 million term loan for leasehold improvement purchases, which bears interest at the bank's prime rate plus 0.50%. These facilities operate as a revolver through June 2000, after which time any outstanding balances must be paid over 36-month and 60-month terms, respectively. These loans also require us to comply with certain financial covenants, including a requirement that we maintain certain financial ratios. We were in compliance with these covenants at March 31, 2000, and at that time there were no borrowings outstanding under these facilities.

As of March 31, 2000, our principal commitments consisted of obligations outstanding under operating leases. In October 1999, we began leasing approximately 126,000 square feet in a single facility located in Bellevue, Washington pursuant to a lease, which expires in 2009. The annual cost of this lease is approximately $3.0 million, subject to annual adjustments. Although we have no other material commitments, we anticipate an increase in our capital expenditures and lease commitments consistent with our anticipated growth in our operations, infrastructure and personnel.

We currently anticipate that we will continue to experience significant increases in our operating expenses for the foreseeable future as we enter new markets for our products and services, increase research and development activities and sales and marketing activities, develop new distribution channels and broaden our professional service capabilities. We believe that our existing cash and cash equivalents and available bank borrowings will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. Although we believe that we will be able to meet our anticipated cash needs after that time from cash generated from operations and do not currently anticipate the need to raise additional capital, if we do seek to raise additional capital, there can be no assurance that additional financing will be available on acceptable terms, if at all. We may use a portion of our cash to acquire additional businesses, products and technologies or to establish joint ventures that we believe will complement our current or future business. However, we have no specific plans, agreements or commitments to do so, and are not currently engaged in any negotiations for any such acquisition or joint venture. Pending such uses, we will invest our surplus cash in government securities and other short-term, investment grade, interest-bearing instruments.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as a part of a hedge transaction and, if it is the type of hedge transaction. This statement is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. We do not use derivative instruments, therefore the adoption of this statement will not have any effect on our results of operations or financial position.

In December 1999, SEC Staff Accounting Bulletin No. 101 ("SAB 101"),"Revenue Recognition in Financial Statements," was issued. This pronouncement summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition. We are required to adopt SAB 101 for the year ended December 31, 2001. We are currently reviewing the requirements of SAB 101 and assessing its impact on our financial statements.

CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

In addition to the factors discussed in the "Liquidity and Capital Resources" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations, the following additional factors may affect our future results.

UNANTICIPATED FLUCTUATIONS IN OUR QUARTERLY OPERATING RESULTS DUE TO FACTORS SUCH AS ADVERSE CHANGES IN OUR RELATIONSHIP WITH MICROSOFT OR A DECLINE IN THE MARKET FOR WINDOWS-BASED INTELLIGENT COMPUTING DEVICES COULD CAUSE OUR STOCK PRICE TO DECLINE SIGNIFICANTLY.

Our operating results have fluctuated in the past, and we expect that they will continue to do so. We believe that period-to-period comparisons of our operating results are not meaningful, and you should not rely on such comparisons to predict our future performance. If our operating results fall below the expectations of stock analysts and investors, the price of our common stock may fall. Factors that may cause our quarterly operating results to fluctuate include:

- the failure or perceived failure of Windows CE, the operating system upon which demand for the majority of our products and services is dependent, to achieve widespread market acceptance;

- the failure of the intelligent computing device market to develop;

- adverse changes in our relationship with Microsoft, from whom a substantial portion of our revenue is generated and on whom we rely to continue to develop and promote Windows CE;

- our inability to develop and market new and enhanced products and services on a timely basis;

- unanticipated delays, or announcement of delays, by Microsoft of Windows product releases, which could cause us to delay our product introductions and adversely affect our customer relationships;

- changes in demand for our products and services;

- increased competition and changes in our pricing as a result of increased competitive pressure;

- our ability to control our expenses, a large portion of which are relatively fixed and which are budgeted based on anticipated revenue trends, in the event that customer projects, particularly Microsoft projects, are delayed, curtailed or discontinued;

- changes in the mix of our services and product revenue, which have different gross margins;

- underestimates by us of the costs to be incurred in significant fixed-fee service projects; and

- varying customer buying patterns which are often influenced by year-end budgetary pressures.

In addition, our stock price may fluctuate due to conditions unrelated to our operating performance, including general economic conditions in the software industry and the market for technology stocks.

SUBSTANTIALLY ALL OF OUR REVENUE, INCLUDING 77% OF OUR TOTAL REVENUE FOR THE THREE MONTHS ENDED MARCH 31, 2000, IS GENERATED FROM OUR RELATIONSHIP WITH MICROSOFT, WHICH CAN BE MODIFIED OR TERMINATED BY MICROSOFT AT ANY TIME.

For the year ended December 31, 1999 and for the three months ended March 31, 2000, approximately 84% and 77% of our revenue, respectively, was generated under our master development and license agreement with Microsoft. The master agreement, the current renewable term of which concludes in July 2000, includes a number of project-specific work plans. We bill Microsoft on a time-and-materials basis, although each project has a maximum dollar cap. We expect the revenue generated from work plans with Microsoft will continue to comprise the majority of our revenue for the next several years. We presently have dedicated approximately 190 of our 330 engineers to these projects. However, the master agreement and each of the individual work plans may be terminated or modified by Microsoft at any time. In addition, there is no guarantee that Microsoft will continue to enter into additional work plans with us. In the past, Microsoft has modified the timing and scope of certain projects, requesting that our engineers be moved from one project to another. For example, in late 1997 Microsoft decided to contract with us to provide Windows CE support services to semiconductor vendors with whom we had previously contracted directly. As a result, from late 1997 through late 1998 our revenue shifted from being generated by a variety of semiconductor vendors to being generated primarily by Microsoft. We do not believe that we could replace the Microsoft revenue in the short- or medium-term if existing work plans were canceled or curtailed, and such cancellations or curtailments would substantially reduce our revenue. Microsoft is a publicly traded company that files financial reports and information with the Securities and Exchange Commission. These reports are publicly available under Microsoft's Exchange Act filing number, 000-14278.

IF THE MARKET FOR THE WINDOWS CE OPERATING SYSTEM FAILS TO DEVELOP FULLY OR DEVELOPS MORE SLOWLY THAN WE EXPECT, OUR BUSINESS AND OPERATING RESULTS WILL BE MATERIALLY HARMED.

Windows CE is one of many operating systems developed for the intelligent computing device market and the extent of its future acceptance is uncertain. Because all of our revenue through 1999 has been generated by software products and services dependent on the Windows CE operating system, if the market for Windows CE fails to develop fully or develops more slowly than we expect, our business and operating results will be significantly harmed. Market acceptance of Windows CE will depend on many factors, including:

- Microsoft's development and support of the Windows CE market. As the developer and primary promoter of Windows CE, if Microsoft were to decide to discontinue or lessen its support of the Windows CE operating system, potential customers could select competing operating systems, which would reduce the demand for our Windows CE-based software products and services. In addition, Microsoft has developed a version of its Windows NT operating system for intelligent computing devices and could decide to shift its support to this operating system to the detriment of Windows CE;

- the ability of the Windows CE operating system to compete against existing and emerging operating systems for the intelligent computing device market including: VxWorks from WindRiver Systems Inc., pSOS from Integrated Systems, Inc., VRTX from Mentor Graphics Corporation, JavaOS from Sun Microsystems, Inc. and LINUX. In particular, in the market for palm-size devices, Windows CE faces intense competition from PalmOS used on 3Com Corporation's Palm devices and to date has had limited success in this market. In the market for cellular phones, Windows CE faces intense competition from the EPOC operating system from Symbian, a joint venture between several of the largest manufacturers of cellular phones, which recently announced it has agreed to discuss cross-licensing its technology with the Palm Computing unit of 3Com. Windows CE may be unsuccessful in capturing a significant share of these two segments of the intelligent computing device market, or in maintaining its market share in those other segments of the intelligent computing device market on which our business currently focuses, including the markets for Internet-enabled television set-top boxes, handheld industrial devices, consumer Internet appliances such as kiosk terminals and vehicle navigational devices, and Windows-based terminals;

- the acceptance by original equipment manufacturers and consumers of the mix of features and functions offered by Windows CE; and

- the willingness of software developers to continue to develop and expand the applications that run on Windows CE. To the extent that software developers write applications for competing operating systems that are more attractive to intelligent computing device end users than those available on Windows CE, potential purchasers could select competing operating systems over Windows CE.

IF THE MARKET FOR INTELLIGENT COMPUTING DEVICES FAILS TO DEVELOP FULLY OR DEVELOPS MORE SLOWLY THAN WE EXPECT, OUR REVENUE WILL NOT GROW AS FAST AS ANTICIPATED, IF AT ALL.

The market for intelligent computing devices is 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 grow as fast as we anticipate, if at all. We are dependent upon the broad acceptance by businesses and consumers of a wide variety of Windows CE-based intelligent computing devices, which will depend on many factors, including:

- the development of content and applications for intelligent computing devices;

- the willingness of large numbers of businesses and consumers to use devices such as handheld and palm-size PCs and handheld industrial data collectors to perform functions currently 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 that facilitate the distribution of content over the Internet to these devices via wired and wireless telecommunications systems, satellite or cable.

IF MICROSOFT ADDS FEATURES TO ITS WINDOWS OPERATING SYSTEM THAT DIRECTLY COMPETE WITH SOFTWARE PRODUCTS AND SERVICES WE PROVIDE, OUR REVENUE COULD BE REDUCED AND OUR PROFIT MARGINS COULD SUFFER.

As the developer of Windows, Microsoft could add features to its operating system that directly compete with the software products and services we provide to our customers. Such features could include, for example, faxing, hardware-support packages and quality-assurance tools. The ability of our customers or potential customers to obtain software products and services directly from Microsoft that compete with our software products and services could harm our business. 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. Moreover, the resulting competitive pressures could lead to price reductions for our products and reduce our profit margins.

IF WE DO NOT MAINTAIN OUR FAVORABLE RELATIONSHIP WITH MICROSOFT, WE WILL HAVE DIFFICULTY MARKETING OUR SOFTWARE PRODUCTS AND SERVICES AND MAY NOT RECEIVE DEVELOPER RELEASES OF WINDOWS CE, AND OUR REVENUE AND OPERATING MARGINS WILL SUFFER.

In the event that our relationship with Microsoft were to deteriorate, then our efforts to market and sell our software products and services to original equipment manufacturers could be adversely affected and our business would be harmed. Microsoft has great influence over the development plans and buying decisions of original equipment manufacturers utilizing Windows CE for intelligent computing devices. Microsoft refers many of our original equipment manufacturer customers to us. Moreover, Microsoft controls the marketing campaigns related to its operating systems, including Windows CE. Microsoft's marketing activities, including trade shows, direct mail campaigns and print advertising, are important to the continued promotion and market acceptance of Windows CE and, consequently, of our Windows CE-based software products and services. We must maintain mutually successful relationships with Microsoft so that we may continue to participate in joint marketing activities with Microsoft, including participating in "partner pavilions" at trade shows and listing our services on Microsoft's website, and to receive referrals from Microsoft. In the event that we are unable to continue our joint marketing efforts with Microsoft or fail to receive referrals from Microsoft, we would be required to devote significant additional resources and incur additional expenses to market our software products and services directly to potential customers. In addition, we depend on receiving from Microsoft developer releases of new versions of and upgrades to Windows CE and related Microsoft software in order to timely develop and ship our products and provide services. If we are unable to receive these developer releases, our revenue and operating margins would suffer.

UNANTICIPATED DELAYS, OR ANNOUNCEMENT OF DELAYS, BY MICROSOFT OF WINDOWS CE PRODUCT RELEASES COULD ADVERSELY AFFECT OUR SALES.

Unanticipated delays, or announcement of delays, in Microsoft's delivery schedule for new versions of its Windows CE operating system could cause us to delay our product introductions and impede our ability to complete customer projects on a timely basis. These delays or announcements by Microsoft could also cause our customers to delay or cancel their project development activities or product introductions. Any resulting delays in, or cancellations of, our planned product introductions or in our ability to commence or complete customer projects may adversely affect our revenue and could cause our quarterly operating results to fluctuate. For example, in 1998 Microsoft delayed the release of a version of its Windows CE Platform Builder, which delayed our introduction of a complementary product for an original equipment manufacturer customer.

OUR MARKET IS BECOMING INCREASINGLY COMPETITIVE, WHICH MAY RESULT IN PRICE REDUCTIONS, LOWER GROSS MARGINS AND LOSS OF MARKET SHARE.

The market for Windows CE-based software products and services is becoming increasingly competitive. In addition, competition is intense for the business of the limited number of original equipment manufacturer customers that are capable of building and shipping large quantities of intelligent computing devices. Increased competition may result in price reductions, lower gross margins and loss of market share, which would harm our business. We face competition from:

- our current and potential customers' internal research and development departments that may seek to develop their own proprietary solutions;

- large professional engineering services firms;

- established intelligent computing device software and tools;

- small- and medium-size engineering services; and

- software and component distributors.

As we develop new products, particularly products focused on specific industries, we may begin competing with companies with whom 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. The barrier to entering the market as a provider of Windows-based intelligent computing device software and services is low. In addition, Microsoft has created a marketing program to encourage systems integrators to work on Windows. These systems integrators are given the same access by Microsoft to the Windows technology as we are, with respect to system integration. New competitors may have lower overhead than us and may therefore be able to offer advantageous pricing. We expect that competition will increase as other established and emerging companies enter the Windows based intelligent computing device market and as new products and technologies are introduced.

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, confidentiality procedures and contractual provisions to protect our intellectual property. These laws and procedures provide only limited protection. We have applied for three patents relating to our engineering work. These patents, if issued, 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, 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 their patent. 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 such 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 many 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 products, 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 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 harm our business and operating results.

THIRD PARTIES COULD ASSERT THAT OUR SOFTWARE PRODUCTS AND SERVICES INFRINGE THEIR INTELLECTUAL PROPERTY RIGHTS, WHICH COULD EXPOSE US TO ADDITIONAL COSTS AND LITIGATION.

Third parties may claim that our current or future software products and services infringe their proprietary rights, and these claims, regardless of their merit, could increase our costs and harm our business. We have not conducted patent searches to determine whether the technology used in our products infringes patents held by third parties. In addition, it is difficult to determine whether our software products and services infringe third-party intellectual property rights, particularly in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies. If we were to discover that one of our software products 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 software product. Moreover, any indemnification we obtain against claims that the technology we license from third parties infringes the proprietary rights of others may not always be available or may be limited in scope or amount. Even if we receive broad third-party indemnification, these indemnitors 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 solutions.

There can be no assurance that infringement or invalidity claims related to the software 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. We expect that software product developers will be increasingly subject to infringement claims, as the number of products and competitors in the software industry grows and the functionality of products in different industry segments overlaps. 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.

IF WE DO NOT RESPOND ON A TIMELY BASIS TO TECHNOLOGICAL ADVANCES AND EVOLVING INDUSTRY STANDARDS, OUR FUTURE PRODUCT SALES COULD BE NEGATIVELY IMPACTED.

The market for Windows-based software products and services is new and evolving. As a result, the life cycles of our products are difficult to estimate. To be successful, we must continue to enhance our current product line and develop new products. 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 business may be harmed if we must delay releases of our products and product enhancements or if these products and product enhancements fail to achieve market acceptance when released. 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 or product enhancements. Such deferrals or failures to purchase would decrease our revenue.

OUR FIVE-YEAR OPERATING HISTORY MAKES IT DIFFICULT TO EVALUATE OUR FUTURE PROSPECTS, AND WE CANNOT ASSURE YOU THAT OUR REVENUE GROWTH RATE WILL NOT DECLINE OR THAT WE WILL BE ABLE TO SUSTAIN OR INCREASE OUR PROFITABILITY.

We were founded in July 1994, generated our first revenue in October 1994 and shipped our first product in November 1996. Accordingly, we have a limited operating history and you should not rely on our past results to predict our future performance. The rate of growth of our revenue over the prior year was 245% from 1996 to 1997, 71% from 1997 to 1998, and 62% from 1998 to 1999. The rate of growth of our revenue over prior periods may continue to decline. We anticipate that our expenses will increase substantially in the foreseeable future as we continue to develop our technology and expand our product and service offerings. These efforts may prove more expensive than we currently anticipate, and we may not succeed in increasing our revenue sufficiently to offset these higher expenses. If we fail to increase our revenue to keep pace with our expenses, we may experience losses.

IF WE ARE UNABLE TO MANAGE OUR GROWTH OUR BUSINESS WILL SUFFER.

Our rapid growth has placed, and is expected to continue to place, a significant strain on our managerial, technical, operational and financial resources. From August 1996 to March 2000, we grew from 21 employees to 409 employees, and we expect rapid growth to continue for the foreseeable future. To manage our growth, we must implement additional management information systems, further develop our operational, administrative and financial systems and expand, train and manage our work force. We will also need to manage an increasing number of complex relationships with customers, marketing partners and other third parties. We cannot guarantee that our systems, procedures or controls will be adequate to support our current or future operations or that our management will be able to effectively manage our expansion. Our failure to do so could seriously harm our ability to deliver products and services in a timely fashion, fulfill existing customer commitments and attract and retain new customers.

OUR INTERNATIONAL OPERATIONS EXPOSE US TO GREATER INTELLECTUAL PROPERTY, MANAGEMENT, COLLECTIONS, REGULATORY AND OTHER RISKS.

In late 1998 we opened offices in Munich, Germany and Tokyo, Japan. For the year ended December 31, 1999 and for the three months ended March 31, 2000, less than 1% of our total revenue was generated by our international offices. Our international 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;

- greater difficulty in managing foreign operations due to the lack of proximity between our home office and our foreign operations;

- longer collection cycles in Japan than we typically experience in the U.S.;

- unfavorable changes in regulatory practices and tariffs;

- adverse changes in tax laws;

- seasonal European sales declines in the summer months;

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

- general economic and political conditions in Asian and European markets.

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.

IF WE CONDUCT FUTURE ACQUISITIONS, THEY COULD PROVE DIFFICULT TO INTEGRATE, DISRUPT OUR BUSINESS, DILUTE SHAREHOLDER VALUE AND ADVERSELY AFFECT OUR OPERATING RESULTS.

Although we currently have no specific understandings, commitments or agreements for any acquisition, we may make investments in complementary companies, services and technologies in the future. If we fail to properly evaluate and execute acquisitions and investments, they may seriously harm our business and prospects. 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 or our management may be distracted from our day-to-day operations. In addition, if we conduct acquisitions using debt or equity securities, existing shareholders may be diluted, which could affect the market price of our stock.

IF WE ARE UNABLE TO LICENSE KEY SOFTWARE FROM THIRD PARTIES OUR BUSINESS COULD BE HARMED.

We often integrate third-party software with our internally developed software to provide software products and services for our original equipment manufacturer customers. If our relationships with our third-party vendors were to deteriorate, we might be unable to obtain licenses on commercially reasonable terms, if at all, for newer versions of their software required to maintain compatibility. In the event that we are unable to obtain additional licenses, we would be required to develop this technology internally, which could delay or limit our ability to introduce enhancements or new products or to continue to sell existing products.

OUR SOFTWARE PRODUCTS OR THE THIRD-PARTY HARDWARE OR SOFTWARE INTEGRATED WITH OUR SOFTWARE PRODUCTS AND SERVICES MAY SUFFER FROM DEFECTS OR ERRORS THAT COULD IMPAIR OUR ABILITY TO SELL OUR SOFTWARE PRODUCTS AND SERVICES.

Software and hardware components as complex as those needed for intelligent computing 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 software products until software 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 resulting in a decline in our gross margins. In addition, it is possible that by the time defects are fixed the market opportunity may have been missed which may result in lost revenue. Moreover, 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 or increased service and warranty costs, all of which could harm our business.

WE MAY BE SUBJECT TO PRODUCT LIABILITY CLAIMS THAT COULD RESULT IN SIGNIFICANT COSTS.

Our license 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 software products and services entail the risk of such claims and we may be subject to such claims in the future. A product liability claim brought against us, whether successful or not, could harm our business and operating results.

THE LENGTHY SALES CYCLE OF OUR PRODUCTS AND SERVICES MAKES OUR REVENUE SUSCEPTIBLE TO FLUCTUATIONS.

Our sales cycle is typically three to six months because the expense and complexity of our products and services 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 our products and services, we frequently must educate our potential customers about the full benefits of our products and services, which can require significant time. If our sales cycle lengthens unexpectedly, it could adversely affect the timing of our revenue which could cause our quarterly results to fluctuate.

A SMALL NUMBER OF OUR EXISTING SHAREHOLDERS CAN EXERT CONTROL OVER US.

Our executive officers, directors and principal shareholders holding more than 5% of our common stock together control a majority of our outstanding common stock. As a result, these shareholders, if they act together, could control our management and affairs of the company and all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control of us and might affect the market price of our common stock.

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 amended and restated 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, as of this year's annual meeting of shareholders, our board of directors will be divided into three classes. The directors in each class will serve for three-year terms, one class being elected each year by our shareholders. This system of electing and removing directors may tend to 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 antitakeover provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

IMPACT OF THE YEAR 2000

We have not experienced any adverse impacts from the transition to the year 2000. We are also not aware of any material year 2000 problems with our vendors, service providers, customers or distribution partners. Accordingly, we do not anticipate incurring material expenses or experiencing any material operational disruptions as a result of any year 2000 issues that may arise.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Interest Rate Risk. We do not hold derivative financial instruments or equity securities in our 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 or issuer to a maximum of 20% 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 mature in 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 Risk. Currently, the majority of our sales and expenses are 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 during the three months ended March 31, 2000 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.

PART II. OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

On January 5, 2000, the Company issued 261,391 shares of its common stock in connection with the acquisition of BlueWater Systems, Inc. The issuance was exempt from registration pursuant to Section 4(2) of the Securities Act.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

On May 2, 2000, the following items were voted on at the Annual Meeting of Shareholders:

PROPOSAL 1: Election of Directors. Two Class I directors are to be elected at the Annual Meeting for a one-year term ending in 2001. Two Class II directors are to be elected at the Annual Meeting for a two-year term ending in 2002. Two Class III directors are to be elected for a three-year term ending in 2003. The Board of Directors has nominated Scot E. Land and William L. Larson for election as Class I directors. The Board has nominated Albert T. Dosser and Jeffrey T. Chambers for election as Class II directors. The Board of Directors has nominated William T. Baxter and David M. Moore for election as Class III directors. The following nominees were elected as directors, each to hold office until his successor is elected and qualified, by the vote set forth below:

| NOMINEE | FOR | WITHHELD |
|---|---|---|
| William T. Baxter | 26,650,980 | 31,838 |
| Albert T. Dosser | 25,650,880 | 31,938 |
| Scot. E. Land | 25,650,665 | 32,153 |
| David M. Moore | 25,649,880 | 32,938 |
| Jeffrey T. Chambers | 25,650,365 | 32,453 |
| William L. Larson | 25,650,080 | 32,738 |

PROPOSAL 2: Ratify and approve an amendment to the stock option plan to annual increase the number of shares reserved for issuance during each of the Company's fiscal years beginning on January 1, 2000 by an amount equal to the lesser of (A) four percent (4%) of the Company's outstanding shares at the end of such fiscal year or (B) an amount determined by the Board of Directors. This proposal was approved by the vote set forth below:

| FOR | AGAINST | ABSTAIN |
|---|---|---|
| 24,005,650 | 1,660,572 | 16,596 |

PROPOSAL 3: Approve an amendment to the Company's Amended and Restated Articles of Incorporation to increase the number of authorized shares of Common Stock from 50,000,000 shares to 150,000,000 shares. This proposal was approved by the vote set forth below:

| FOR | AGAINST | ABSTAIN |
|---|---|---|
| 24,006,998 | 1,666,107 | 9,713 |

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits

11.1 Statement re: computation of net income per share

27.1 Financial Data Schedule

(b) Reports on Form 8-K

On January 18, 2000, the Company filed a Form 8-K under Items 2 and 7 announcing that the Company entered into a definitive agreement to acquire BlueWater Systems, Inc.

SIGNATURE

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)

Brian V. Turner
-----------------------------
Date: May 5, 2000
Brian V. Turner
Senior Vice President of Operations,
Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)

BSQUARE CORPORATION

INDEX TO EXHIBITS


| EXHIBIT NUMBER (REFERENCED TO ITEM 601 OF REGULATION S-K) | EXHIBIT DESCRIPTION |
|---|---|
| 11.1 | Statement re: computation of net income per share. |
| 27.1 | Financial Data Schedule. |

EXHIBIT 11.1

BSQUARE CORPORATION
STATEMENT REGARDING COMPUTATION OF EARNINGS PER SHARE
(in thousands, except per share amounts)

The following table provides a reconciliation of the numerators and denominators used in calculating basic and diluted earnings per share for the three-month periods ended March 31, 2000 and 1999:

| | Three Months Ended March 31, 2000 | 1999 |
|---|---|---|
| Net income (numerator diluted) | $ 995 | $ 429 |
| Less: Accretion of mandatorily redeemable Convertible preferred stock | -- | (30) |
| Net income available to common shareholders (numerator basic) | $ 995 | $ 399 |
| Shares (denominator basic): | | |
| Weighted average common shares outstanding | 32,566 | 18,458 |
| Basic earnings per share | $ 0.03 | $ 0.02 |
| Shares (denominator diluted) (1): | | |
| Weighted average common shares outstanding | 32,566 | 18,458 |
| Mandatorily redeemable convertible preferred stock | -- | 8,333 |
| Common stock equivalents | 3,062 | 1,677 |
| Weighted average common shares and equivalents outstanding | 35,628 | 28,468 |
| Diluted earnings per share | $ 0.03 | $ 0.02 |

(1) Share amounts presented for 1999 give effect to the issuance of 261,391 shares to the former shareholders of BlueWater Systems to effect its acquisition by BSQUARE. The transaction was accounted for as a pooling of interests.

| | |
|---|---|
| 3-MOS | 3-MOS |
| DEC-31-2000 | DEC-31-1999 |
| JAN-01-2000 | JAN-01-1999 |
| MAR-31-2000 | MAR-31-1999 |
| 59,358,000 | 9,294,000 |
| 26,869,000 | 0 |
| 6,648,000 | 5,031,000 |
| (157,000) | (90,000) |
| 0 | 0 |
| 93,297,000 | 14,701,000 |
| 8,249,000 | 5,015,000 |
| (2,556,000) | (1,672,000) |
| 100,412,000 | 18,317,000 |
| 9,496,000 | 3,928,000 |
| 0 | 0 |
| 0 | 14,337,000 |
| 0 | 0 |
| 91,722,000 | 52,000 |
| (806,000) | (366,000) |
| 100,412,000 | 18,317,000 |
| 0 | 0 |
| 13,292,000 | 9,167,000 |
| 6,349,000 | 4,185,000 |
| 5,735,000 | 4,263,000 |
| 620,000 | 0 |
| 0 | 0 |
| (826,000) | (54,000) |
| 1,414,000 | 773,000 |
| 419,000 | 344,000 |
| 995,000 | 429,000 |
| 0 | 0 |
| 0 | 0 |
| 0 | 0 |
| 995,000 | 429,000 |
| 0.03 | 0.02 |
| 0.03 | 0.02 |