BSQUARE CORP /WA
Form 10-Q
November 13, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2014

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)

	1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
Washington									
Code	V			Amount	(A) or (D)	Price			

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares
Employee Stock Option (right to buy)	$ 0.91	10/07/2005		A		300,000		(1)	10/08/2015	Common Stock	300,00 (1)

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Arovas Robert 950 WILSON STREET LAGUNA BEACH, CA 92651			President	

Signatures

/s/ Robert Arovas	D

Stock Option (Right to Buy)	$ 7.2	12/16/2014	M	1,171	(4)	09/08/2024	Common Stock	1,171	$ 0	17,569	D

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Waddill William D. C/O CALITHERA BIOSCIENCES, INC.			SENIOR VP & CFO	

343 OYSTER POINT BLVD. #200
SOUTH SAN FRANCISCO, CA 94080

Signatures

/s/ William D. Waddill	12/18/2014
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Shares are held directly by William and Katherine Waddill Trust Dated July 26, 2000, of which Reporting Person is a Trustee.

(2) The shares acquired in connection with the option exercise are subject to a lock-up agreement that restricts the transfer of these shares prior to March 31, 2015. No shares are being sold by the Reporting Person.

(3) 1/48 of the Option vests in equal monthly installments one month from 4/1/2014. The option shall be subject to accelerated vesting as set forth in the optionee's employment agreement with the Company.

(4) 1/48 of the Option vests in equal monthly installments one month from 9/9/2014. The option shall be subject to accelerated vesting as set forth in the optionee's employment agreement with the Company.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

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FORM 10-Q

For the Quarterly Period Ended September 30, 2014

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	September 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$12,575	$13,510
Short-term investments	12,646	7,295

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OWNERSHIP OF GRAINGER STOCK

The table below shows how many shares of Grainger common stock the directors, the nominees, certain executive officers, and all directors and executive officers as a group beneficially owned as of March 1, 2004.

Beneficial ownership is a term broadly defined by the SEC. In general, a person beneficially owns securities if the person, alone or with another, has voting power or investment power (the power to sell) over the securities. Being able to acquire either power within 60 days, such as by exercising stock options, also results in beneficial ownership of securities. Unless otherwise indicated in the footnotes following the table, each of the named persons had beneficial ownership of the indicated number of Grainger shares by sole voting and investment power.

Beneficial Owner	Shares	Option Shares Exercisable Within 60 Days (1)	Stock Units (2)	Total	Percentage of Common Stock (3)
David W. Grainger (4), (5) 100 Grainger Parkway Lake Forest, IL 60045	9,607,988	-0-	-0-	9,607,988	10.6%
James D. Slavik (6), (7)	4,272,953	13,620	5,958	4,292,531	4.7%
Brian P. Anderson	3,690	9,960	1,793	15,443	*
Wesley M. Clark (8)	50,000	208,690	15,000	273,690	*
Wilbur H. Gantz	10,690	13,620	10,304	34,614	*
Richard L. Keyser (8), (9)	158,580	488,470	33,595	680,645	*
Frederick A. Krehbiel	7,030	3,630	622	11,282	*
P. Ogden Loux (8), (10)	26,566	154,470	7,500	188,536	*
John W. McCarter, Jr. (11)	11,890	13,620	4,171	29,681	*
Neil S. Novich	4,690	9,960	1,528	16,178	*
James T. Ryan (8) (12)	31,886	47,270	-0-	79,156	*

Beneficial Owner	Shares	Option Shares Exercisable Within 60 Days (1)	Stock Units (2)	Total	Percentage of Common Stock (3)
John W. Slayton, Jr. (8) (13)	46,024	93,790	5,000	144,814	*
Harold B. Smith (14)	43,890	13,620	5,958	63,468	*
Janiece S. Webb (15)	10,652	13,620	4,943	29,215	*
Directors and Executive Officers as a group (8), (16), (17)	14,436,431	1,393,120	113,622	15,943,173	17.1%

1. In computing the percentage of shares owned by each person and by the group, these shares were added to the total number of outstanding shares for the separate calculations.

2. Represents the number of stock units credited to the accounts of non-employee directors under the Director Stock Plan and the number of restricted stock units credited to the accounts of executive officers under the 1990 Long Term Stock Incentive Plan. Each stock unit is intended to be the economic equivalent of a share of Grainger common stock. These units are excluded from the computations of percentages of shares owned.

3. An asterisk (*) indicates less than 1%.

4. Mr. Grainger is known to be the beneficial owner of more than 5% of Grainger's common stock.

5. Includes 2,197,196 shares as to which Mr. Grainger has shared voting and investment power.

6. Includes 2,691,947 shares as to which Mr. Slavik has shared voting and/or investment power.

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7. Excludes 705,046 shares held by certain of Mr. Slavik's family members, as to which shares Mr. Slavik disclaims voting or investment power.

8. Includes shares of restricted stock as follows: Mr. Clark, 50,000 shares; Mr. Keyser, 100,000 shares; Mr. Loux, 20,000 shares; Mr. Ryan, 22,000 shares; Mr. Slayton, 20,000 shares; and all directors and executive officers as a group, 342,000 shares. These shares are not transferable and are subject to forfeiture during the restricted period.

9. Includes 58,480 shares as to which Mr. Keyser has shared voting and investment power with his wife.

10. Excludes 400 shares held by Mr. Loux's wife, as to which shares Mr. Loux disclaims voting or investment power.

11. Includes 11,890 shares as to which Mr. McCarter has shared voting and investment power with his wife.

12. Includes 1,446 shares as to which Mr. Ryan has shared voting and investment power with his wife.

13.

Includes 26,024 shares as to which Mr. Slayton has shared voting and investment power with his wife.

14. Includes 32,000 shares as to which Mr. Smith has shared voting and investment power.

15. Excludes 350 shares held by Ms. Webb's husband, as to which shares Ms. Webb disclaims voting or investment power.

16. Includes 5,026,223 shares as to which members of the group have shared voting and/or investment power.

17. Excludes 705,796 shares held by certain family members, as to which shares members of the group disclaim voting or investment power.

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SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires that Grainger's directors, executive officers, and 10% shareholders file with the SEC reports concerning their ownership, and changes in their ownership, of Grainger equity securities. Based on a review of copies of the reports provided to Grainger during 2003 and representations of those persons, Grainger believes that these filing requirements were met during the year.

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REPORT OF THE AUDIT COMMITTEE OF THE BOARD

The Audit Committee of the Board of Directors assists the Board in fulfilling its oversight responsibilities. The Board has determined that each of the members of the Audit Committee is "independent," as that term is defined in the independence requirements for audit committee members contained in the applicable rules of the Securities and Exchange Commission and standards of the New York Stock Exchange. The Audit Committee acts under a charter adopted by the Board. A copy of the charter is attached to this proxy statement as Appendix A.

Management is responsible for the Company's internal controls and the financial reporting process. Grant Thornton LLP, the Company's independent auditors, is responsible for performing an independent audit of the Company's consolidated financial statements in accordance with auditing standards generally accepted in the United States of America and to issue a report thereon. The Audit Committee's responsibility is to monitor and oversee these processes.

In performing these responsibilities, the Audit Committee reviewed and discussed the Company's audited consolidated financial statements with management and Grant Thornton LLP. The Audit Committee discussed with Grant Thornton LLP matters required to be discussed by the Statement on Auditing Standards No. 61 "Communication with Audit Committees." Grant Thornton LLP also provided to the Audit Committee the letter and written disclosures required by Independence Standards Board Standard No. 1 "Independence Discussions with Audit Committees" and the Audit Committee discussed with Grant Thornton LLP the matter of the firm's independence.

Based on the review and discussions described above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the Securities and Exchange Commission.

Brian P. Anderson
(Chairman)
Wilbur H. Gantz
Frederick A.
Krehbiel

James D. Slavik
Janiece S. Webb

Members of the
Audit Committee
of the Board of
Directors

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EXECUTIVE COMPENSATION

Summary Compensation Information

This table provides summary information about compensation paid to or accrued for the named executive officers for services during the years ended December 31, 2003, 2002, and 2001.

		Annual Compensation		Long-Term Compensation Awards		
Name and Principal Position (at 12/31/2003)	**Year**	**Salary (1)**	**Bonus (2)**	**Grainger Restricted Stock Awards (3)(4)**	**Stock Options (Shares)**	**All Other Compensation (5)**
Richard L. Keyser Chairman of the	2003	$1,000,040	$686,028	-0-	174,000	$145,710
Board and Chief Executive Officer	2002	963,050	617,425	-0-	175,000	176,234
	2001	832,080	726,406	$1,040,101	183,100	134,937
Wesley M. Clark	2003	$670,040	$364,022	-0-	80.000	$89,175
President and Chief Operating	2002	651,290	327,620	-0-	80,000	113,747
Officer	2001	556,700	446,231	$885,400	78,890	83,678
P. Ogden Loux	2003	$420,020	$196,010	-0-	45,000	$52,578
Sr. Vice President, Finance and	2002	411,020	176,409	-0-	45,000	67,370
Chief Financial Officer	2001	364,020	247,170	$232,200	42,800	53,911
James T. Ryan	2003	$370,040	$134,765	-0-	30,000	$42,991
Exec. Vice President, Marketing,	2002	355,040	121,289	-0-	30,000	45,124
Sales and Service	2001	277,940	92,422	$65,326	50,000	35,727
John W. Slayton, Jr. (6)	2003	$345,020	$113,757	-0-	23,000	$38,985
Sr. Vice President, Supply Chain	2002	336,275	102,381	-0-	25,000	45,175
Management	2001	290,040	111,665	$154,800	21,440	42,824

(1) Represents fixed annual salary and car allowance. Salary increases in 2002 were effective April 1, 2002. There were no salary increases in 2003.

(2) Represents amounts paid under annual cash incentive programs.

(3) Represents values on the dates of award of restricted shares of Grainger common stock. Restricted shares have the same rights, including dividend and voting rights, as other shares of Grainger common stock. As of December 31, 2003, Messrs. Keyser, Clark, Loux, Ryan, and Slayton held 100,000, 50,000, 20,000, 22,000, and 20,000 restricted shares, having then-current market values of $4,739,000, $2,369,500, $947,800, $1,042,580, and $947,800, respectively. Scheduled vesting of the restricted shares ranges from 2005 to 2008, in all cases assuming continued employment with Grainger. Acceleration of vesting of all restricted shares will occur in the event of the holder's death or disability or a "change in control" of Grainger.

(4)

Included with respect to 2001 are 33,595, 15,000, 7,500, 2,110, and 5,000 restricted shares of Grainger common stock awarded to Messrs. Keyser, Clark, Loux, Ryan, and Slayton, respectively, pursuant to the Executive Stock Purchase Program. Under the Program, the named individuals respectively purchased on March 26, 2001 from Grainger 134,380, 60,000, 30,000, 8,440, and 20,000 unrestricted shares of Grainger common stock at the shares' then-current market value and received a 25% match in restricted shares. The restricted shares vested on March 26, 2003. In 2002, Messrs. Keyser, Clark, Loux, and Slayton converted the restricted shares into a like

number of restricted stock units having the same vesting provisions. The restricted stock units are to be settled, at various times after vesting, by the delivery of unrestricted shares of Grainger common stock on a 1-for-1 basis. As of December 31, 2003, Messrs. Keyser, Clark, Loux, and Slayton held 33,595, 15,000, 7,500, and 5,000 restricted stock units having values, based on the then-current market value of Grainger common stock, of $1,592,067, $710,850, $355,425, and $236,950, respectively.

(5)

Represents contributions accrued under Grainger's profit sharing plan, in which most Grainger employees participate, and the related supplemental profit sharing plan.

(6)

Mr. Slayton retired as an officer of Grainger in 2004.

Stock Option Grants

This table contains information about grants of stock options during the year ended December 31, 2003 to the named executive officers.

Name	**Options Granted (Shares)**	**Percentage of Total Options Granted to Employees in 2003**	**Exercise or Base Price (Per Share) (1)**	**Earliest Exercise Date (2)**	**Expiration Date**	**Grant Date Present Value (3)**
Richard L. Keyser	174,000	9.45%	$45.50	4/30/2006	4/29/2013	$1,806,120
Wesley M. Clark	80,000	4.35%	45.50	4/30/2006	4/29/2013	830,400
P. Ogden Loux	45,000	2.44%	45.50	4/30/2006	4/29/2013	467,100
James T. Ryan	30,000	1.63%	45.50	4/30/2006	4/29/2013	311,400
John W. Slayton, Jr.	23,000	1.25%	45.50	4/30/2006	4/29/2013	238,740

(1)

The option exercise price equals the closing price of Grainger common stock reported for the business day before the date of grant.

(2)

All options were granted under the 2001 Long Term Stock Incentive Plan on April 30, 2003 and are scheduled to become fully exercisable three years following that date. The exercisability of all unexercisable options is accelerated upon an optionee's death, disability or retirement, or upon a "change in control" of Grainger.

(3)

The amounts shown are based on the Black-Scholes option-pricing model. Material assumptions incorporated into this model in estimating the value of the options are consistent with those required by Statement of Financial Accounting Standards No. 123 (Accounting for Stock-Based Compensation) and include the following:

a.

Exercise prices based on 100% of the fair market values of the shares on the dates of grant.

b.
Expected term of 7 years.

c.
Interest rate of 3.39%.

d.
Volatility of 20.13%.

e.
Dividend yield of 1.77%.

The actual value, if any, an executive may realize will depend on the excess of the stock price over the exercise price on the date the option is exercised. There is no assurance that the value realized by an executive will be at or near the value estimated by the Black-Scholes model.

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Stock Option Exercises and Holdings

This table contains information about the number of shares of Grainger common stock covered by, and the values of, outstanding stock options held by the named executive officers at December 31, 2003. None of the named executive officers exercised stock options during 2003.

	Number of Securities Underlying Unexercised Options at 12/31/2003		Value of Unexercised In-the-Money Options at 12/31/2003 (1)	
Name	**Exercisable**	**Unexercisable**	**Exercisable**	**Unexercisable**
Richard L. Keyser	310,435	535,135	$1,507,403	$2,151,525
Wesley M. Clark	139,112	240,348	653,602	937,094
P. Ogden Loux	113,420	133,850	635,239	512,426
James T. Ryan	42,270	115,000	154,909	570,650
John W. Slayton, Jr.	80,210	69,980	593,899	257,612

(1)
The dollar amounts shown are the differences between the per-share stock option exercise prices and the closing price of Grainger common stock on December 31, 2003 of $47.39 per share, as reported in the Composite Tape for NYSE listed stocks, multiplied by the number of shares covered by the unexercised stock options.

Other Benefits

The Executive Deferred Compensation Plan permitted participants selected by a committee of management prior to 1986 to elect a salary reduction of between 5% and 15% (or more with special agreement) for up to four years. Under the related Plan Agreement, a participant is entitled to 180 monthly payments, commencing at age 65, in an annual amount that is based upon the amount of the salary reduction, the additional amount allocated by Grainger, and the number of years from deferment to normal retirement age. Reduced or increased payments are provided if the participant begins receiving payments before or after age 65, respectively. If Grainger reduces Plan benefits or terminates the Plan, or if there is a "change in control" of Grainger, various benefits are provided to the participant, ranging from a return of the amount of salary deferral plus interest to a lump-sum benefit equal to the present value of a projected payment stream. If a participant dies before retirement or before having received the full amount of the benefits, the balance will be paid to the participant's designated beneficiary. Although payment deferrals have not been permitted for several years, Mr. Keyser and certain other key executives had elected to defer salary payments under the Plan for prior years. If Mr. Keyser commences receiving payments under the Plan at age 65, his monthly payments would be $10,509.

A committee of Grainger management determines participation in Grainger's Executive Death Benefit Plan. The beneficiary of a participant who dies while employed by Grainger is generally entitled to 120 monthly payments of 50% of the participant's monthly compensation, calculated on the basis of salary and target bonus under the applicable cash incentive program. If a participant dies after retirement, an after-tax, lump-sum benefit approximating the participant's annual salary and annual target bonus under the applicable cash incentive program is payable to the participant's designated beneficiary. Prior to retirement, however, a participant may elect to receive a reduced payment following retirement on a pre-death basis. In the event of a "change in control" of Grainger, the Plan

assumes retirement on that date if the participant is then eligible for retirement (with the participant being credited with an additional three years of age and service for this purpose). The Plan then provides for a lump-sum payment of the present value of the post-retirement benefit on the basis of the participant's death at age 80. All of the named executive officers and certain other key executives participate in the Plan.

Grainger has purchased and owns life insurance contracts to reduce its exposure relating to the Executive Deferred Compensation Plan and the Executive Death Benefit Plan.

All of the named executive officers and certain other key executives have entered into Change In Control Employment Agreements with Grainger. Under each Agreement, the executive is entitled to certain benefits if, within a two-year period following a "change in control" of Grainger, (a) the executive's employment is terminated other than for "cause," (b) the executive terminates employment for "good reason," or (c) in the case of Mr. Keyser and certain of the other named executive officers, the executive terminates employment for any reason within the 30-day period following the one-year anniversary of the "change in control." Benefits include a lump-sum payment generally equal to a multiple of the sum of (i) the executive's annual salary, (ii) the higher of the executive's target annual bonus or the average of the executive's last three annual bonuses, and (iii) in connection with Grainger's non-contributory profit sharing plans, a percentage of annual salary and bonus equal to the greater of (x) the highest percentage of covered compensation contributed by Grainger under the plans for any of the last three fiscal years or (y) 15%. In the case of Mr. Keyser and certain of the other named executive officers, the multiple is three. In the case of most of the other key executives, the multiple is two. Benefits additionally include continuation of health and dental benefits for a number of years equal to the applicable multiple. Each Agreement further provides that the executive is to be made whole on an after-tax basis with respect to excise tax due as a consequence of payments (whether or not under the Agreement) being classified as "parachute payments" under Section 280(g) of the Internal Revenue Code of 1986, as amended. In certain cases the lump-sum payment upon termination is limited under the Agreement to an amount above which this excise tax would be due.

U.S. employees who have not entered into Change In Control Employment Agreements with Grainger are generally covered by a Change In Control Severance Policy. Under the Policy, employees whose employment with Grainger is terminated other than for "cause" or who resign under certain circumstances within two years following a "change in control" of Grainger are entitled to certain benefits. These benefits are severance pay and continuation of health and dental benefits in amounts and for durations that are based upon years of service, pay, and other factors.

EQUITY COMPENSATION PLANS

This table contains information as of December 31, 2003 about Grainger's equity compensation plans, consisting of the 1990 Long Term Stock Incentive Plan, the 2001 Long Term Stock Incentive Plan, and the Director Stock Plan. All of these plans have been approved by Grainger's shareholders.

	Number of common shares to be issued upon exercise of outstanding options, warrants, and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of common shares available for future issuance under equity compensation plans (excluding common shares reflected in the first

			column)	
Equity compensation plans approved by shareholders	10,413,932	$ 44.91	2,016,160	(1)
Equity compensation plans not approved by shareholders	-0-	N/A	-0-	
Total	10,413,932	$ 44.91	2,016,160	

(1) Included are 859,600, 809,930, and 346,630 shares that may be issued under the 1990 Long Term Stock Incentive Plan, the 2001 Long Term Stock Incentive Plan, and the Director Stock Plan, respectively, in connection with awards of stock options, stock appreciation rights, stock units, shares of common stock, restricted shares of common stock, and other stock-based awards. No more than 600,000 shares, however, may be issued under the 2001 Long Term Stock Incentive Plan by reason of awards of shares of common stock or restricted shares of common stock.

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REPORT OF THE COMPENSATION COMMITTEE OF THE BOARD

This report of the Compensation Committee of the Board (the "Committee") discusses the Company's compensation policy and programs for the Chairman and Chief Executive Officer and others who served as executive officers during the year.

The Committee, all members of which are Independent Directors, administers the Company's executive compensation programs, reviews and approves corporate goals relevant to compensation, evaluates performance, and recommends to the Board the compensation design and pay levels for all executive officers. The Committee's charter, which sets out its duties and responsibilities, can be found in the Investor Relations section of the Company's Web site, www.grainger.com. The Committee considers information and data supplied by management and by compensation and benefits consultants. In 2003, the Committee retained an independent compensation consultant, who reports directly to the Committee.

Executive Compensation Policy

The Company's compensation programs are designed to attract and retain high-quality executive and managerial talent and to provide appropriate incentives, including equity based awards, for achieving the Company's business goals. The overall program includes significant variable pay components which link total executive compensation to performance and to the creation of long term shareholder value.

The Company endeavors to accomplish these objectives through executive officer compensation consisting of base salary, cash incentive compensation, stock options, restricted stock and benefits. When Company performance is at target, the Company's objective is to pay executive officers at median. This means the Company intends total compensation to be at or near the size-adjusted median of total compensation paid to similar executive positions at a representative group of other companies that are considered to be comparative as competitors for executive talent. All elements of compensation are valued to determine annually the Company's relative position against these comparator companies.

The compensation comparator group used is reviewed regularly by the Compensation Committee, with input from consultants. The current comparator group is similar in size (based on revenues and market capitalization) to the Company and is representative of the types of major companies with whom the Company historically competes for executive talent. This "competitive market" for executive talent is not necessarily the same as is used for industry or sector performance considerations. Therefore, companies used for compensation comparison purposes are not identical to those in the industry indices used in the performance graph of company total shareholder returns.

Base Salaries

The Committee reviews base salaries annually. Adjustments to base salaries are determined based on a detailed evaluation of individual performance, the competitive market, executive experience and internal equity issues. In 2003, however, elected officers did not receive base salary increases, other than limited promotion-related adjustments.

Cash Incentives

Executive officers and other key managers generally participate in the Management Incentive Plan (MIP), which provides for cash incentives based on the achievement of specified financial

performance measures. For 2003, the MIP was structured to provide a balance between short term and long term results and to align the interests of management with shareholders by providing incentive payments that correspond with long term creation of shareholder value. For 2003, the financial measures used were return on invested capital (ROIC) and year-over-year growth in revenue. These measures were selected as they balance revenue growth with profitability, expense management and asset management.

Target incentive awards under the MIP and similar programs are based on a review of competitive market practice and range from 10% to 100% of base salary. Actual MIP payments are a product of the incentive target adjusted by the actual results achieved under the financial measures. Incentive awards for executive officers in charge of business units were primarily based on the performance of the individual unit, although these executive officers also participated in the Company MIP results with respect to a portion of their total incentive opportunity.

Results for 2003 were above target on ROIC, but were below target for year-over-year growth in sales. These results translated to an actual incentive multiple that caused the 2003 incentive awards to be lower than the target incentive awards. In lieu of 2003 base salary increases, the Company established a one-time incentive program for 2003 whereby elected officers would receive 3.0% of their base salary if the Company achieved certain performance goals. The Company performance fell short of these goals, so the one-time awards were not paid.

The Chairman and Chief Executive Officer and President and Chief Operating Officer participated in the Office of the Chairman Incentive Program, a separate shareholder approved plan providing for incentive bonuses determined by reference to the Company's reported net earnings. Bonuses under this plan were calculated for the year using the same financial measures as MIP incentives for most other executive officers.

In 2004, the Company intends to continue to use ROIC and year-over-year growth in revenue for its incentive program. In addition, the Company will introduce an individual performance component that could amount to up to 30% of the target incentive. The individual performance component will be paid based on an assessment of the individual's achievement against specific goals related to Company objectives.

Stock Options

The annual stock option program is considered an important means of aligning the financial interests of executive officers and other key employees to the longer term financial interests of the shareholders. The number of shares covered by options awarded at each level in the organization is designed to provide an economic value that is competitive with awards made by other companies to their employees in comparable jobs. Recipients are required to sign an agreement containing confidentiality and non-competition provisions to receive a stock option award. In April 2003, approximately 650 employees received stock options covering 1.7 million shares through this shareholder approved program. This number includes approximately 0.5 million stock options awarded to 12 executive officers. To promote retention of key talent, three-year cliff vesting provisions are used for most awards.

The Company also periodically issues options to its employees under the broad-based stock option program. Under this program, employees who do not participate in any other option program are awarded stock options covering 100 shares upon reaching five-year service-level milestones.

Under this broad-based program, 1,850 employees received options covering 185,000 shares. The general option terms are similar to those of the annual stock option program.

In all cases, stock options are awarded at an exercise price equal to the closing price of the Company's common stock reported for the business day before the grant. Stock option repricing is not permitted under the plan.

Restricted Stock and Restricted Stock Units

The Company has granted restricted stock (generally subject to forfeiture if employment terminates before the end of the restriction) to executive and other officers of the Company, in each case subject to the execution of a confidentiality and non-competition agreement with the Company. The objectives of the grants and related confidentiality and non-competition agreements are to align more closely the interests of executives with those of shareholders, to protect proprietary Company information, to preserve the Company's competitive advantages, to provide a strong executive retention incentive, and to provide for executive continuity.

In March 2001, a number of executive officers and other key managers purchased 787,020 treasury shares from the Company at the then-current market price. Most executives financed their purchases through bank loans that were guaranteed by the Company. Cash proceeds from the sale, which amounted to $24.4 million, were used by the Company to repurchase shares of the Company's stock on the open market. Executives who met a threshold purchase requirement of one times their annual base salary received a 25% matching grant of restricted stock. Vesting restrictions imposed by the Company ended on March 26, 2003 and individual loans became due on April 16, 2003. As of December 31, 2003, all loans payable were settled between each executive and the bank. The 25% matching grant totaled 192,275 shares, 95,720 of which were subsequently converted into restricted stock units to be settled after vesting by delivery of a like number of shares of Company stock. In compliance with new statutory requirements, the Company will not continue this program.

Beginning in 2004, the Company intends to use restricted stock units as a part of its annual long term incentive program for top management. To keep the target grant value of long term incentives consistent with Company pay objectives and median market practice, the target annual stock option awards were lowered from the 2003 levels, reflecting the accompanying award of restricted stock units. The partial substitution of restricted stock units is intended to reduce annual share usage, increase the retentive qualities (given four-year cliff vesting provisions), and lessen the primary reliance on stock options with respect to the annual programs.

Stock Ownership Guidelines

In 1996, the Company established stock ownership guidelines for its officers. Ownership of Company stock creates alignment between executives and shareholders and encourages executives to act to increase shareholder value. The Chairman and Chief Executive Officer is required to achieve stock ownership of at least five times annualized base salary. The President and Chief Operating Officer is required to achieve stock ownership of at least four times annualized base salary. Other U.S. officers are required to achieve stock ownership of at least three times or two times annualized base salary. These ownership guidelines must be met within three years of being elected an officer. Officers who fail to achieve these ownership levels will not be eligible to receive any stock-based awards until they achieve their required ownership level. As of the date of this report, all officers subject to the guidelines are in compliance with them. The Company believes the guidelines are important in aligning the interests of the executive officers of the Company and the shareholders.

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Deferred Compensation

Beginning in 2004, officers of the Company may elect to defer receipt of up to 50% of base salary and/or 85% of annual cash bonus under an unfunded deferred compensation plan. The rate of return on the individual accounts (positive or negative) will be a function of the participant-selected investment funds. Investment choices for employees who elect to defer salary and/or bonus generally may be made from the same investment funds available under the Company's profit sharing plan.

Other Benefits

Most other benefits, including profit sharing and various welfare benefits, provided to executive officers are comparable to those provided to the majority of salaried and hourly Company employees.

Deductibility of Executive Compensation

Section 162(m) of the Internal Revenue Code generally disallows a federal income tax deduction to a public company for compensation over $1 million per fiscal year paid to the company's chief executive officer and its four other most highly compensated executive officers serving at the end of that year. Not subject to the deductibility limit, however, is compensation that qualifies as "performance-based" compensation. A Company objective is to maximize the deductibility of compensation under Section 162(m) to the extent doing so is reasonable and consistent with Company strategies and goals. Awards under the cash incentive plan in which the Chairman and Chief Executive Officer and President and Chief Operating Officer participate and gains on exercises of stock options awarded under the 1990 and 2001 Long Term Stock Incentive Plans are considered to be "performance-based" compensation not subject to the Section 162(m) deductibility limit.

Harold B. Smith, Chairman
Wilbur H. Gantz
Neil S. Novich
James D. Slavik

Members of the Compensation Committee
of the Board of Directors

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COMPANY PERFORMANCE

This stock price performance graph compares the cumulative total return on an investment in Grainger common stock with the cumulative total return of an investment in each of the S&P 500 Stock Index and the Dow Jones Industrial Services Index. It covers the period commencing December 31, 1998 and ending December 31, 2003. The graph assumes that the value for the investment in Grainger common stock and in each index was $100 on December 31, 1998 and that all dividends were reinvested.

PROPOSAL TO RATIFY THE APPOINTMENT OF INDEPENDENT AUDITORS

The Audit Committee of the Board of Directors has approved, subject to shareholder ratification at the meeting, the appointment of Grant Thornton LLP as Grainger's independent auditors for the year ending December 31, 2004. Representatives of Grant Thornton LLP are expected to be present at the meeting to respond to appropriate questions of shareholders and to make any desired statements.

The following table sets forth the fees that were billed to Grainger by Grant Thornton LLP for professional services rendered with respect to fiscal years 2003 and 2002:

Fee Category	2003	2002
Audit Fees	$615,063	$574,899
Audit Related Fees	150,656	146,123
Tax Fees	51,755	43,125
All Other Fees	-0-	-0-
Total Fees	$817,474	$764,147

Audit Fees. Consists of fees billed for professional services rendered for the audit of Grainger's annual financial statements, review of the interim financial statements included in Grainger's quarterly reports on Form 10-Q, and other services normally provided in connection with Grainger's statutory and regulatory filings or engagements.

Audit-Related Fees. Consists of fees billed for professional services rendered for assurance and related services that are reasonably related to the performance of the audit or review of Grainger's financial statements. These services include the audits of Grainger's employee benefit plans, the review of documentation related to the implementation of Section 404 of the Sarbanes-Oxley Act, and various attest services.

Tax Fees. Consists of fees billed for professional services rendered for tax compliance, tax advice and tax planning. These services include assistance with the preparation of various tax returns.

All Other Fees. Consists of fees billed by Grant Thornton LLP for all other professional services rendered to Grainger. No such services were rendered during fiscal years 2003 and 2002.

Pre-Approval Policy for Audit and Non-Audit Services

The Audit Committee has adopted a policy for the pre-approval of all audit and permitted non-audit services to be provided by Grainger's independent auditors. Also, specific pre-approval by the Audit Committee is required for any proposed services exceeding pre-approved cost levels. The Audit Committee may delegate pre-approval authority for audit and non-audit services to one or more of its members, and such authority has been delegated to the Chairman of the Audit Committee. The decisions of any member to whom such authority is delegated must be presented to the full Audit Committee at its next scheduled meeting. The Audit Committee periodically reviews reports summarizing all services provided by the independent auditors.

The Board recommends a vote FOR the proposal to ratify the appointment of independent auditors.

Approval of the proposal requires the affirmative votes of a majority of the shares of Grainger common stock represented in person or by proxy at the meeting and entitled to vote. Abstentions will have the same effect as votes against the proposal. Broker non-votes will not affect the outcome of the vote. In the event the proposal is not approved, the Board will consider the negative vote as a mandate to appoint other independent auditors for the next year.

Appendix A

CHARTER OF THE AUDIT COMMITTEE OF THE BOARD
(As Amended December 10, 2003)

The Audit Committee shall be comprised solely of at least three independent Directors who shall meet the criteria for independence required by the New York Stock Exchange and the Sarbanes-Oxley Act of 2002.

Directors shall be elected to the Committee annually at the April meeting of the Board. The members of the Committee shall serve until their successors are elected and qualified or until their earlier resignation or removal. The Board shall have the power at any time to change the membership of the Committee and to fill vacancies.

All members of the Committee shall be financially literate, and at least one member shall be an "audit committee financial expert," as defined by Securities and Exchange Commission (SEC) regulations.

I. General Responsibilities of the Committee

A.

Oversight. The Committee shall assist the Board in its oversight responsibilities with respect to the Company's financial reporting process, the systems of internal accounting and financial controls, the integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements, the independent auditor's qualifications and independence, and the performance of the Company's internal audit function and independent auditor.

While the primary responsibility of the Committee is to oversee the Company's financial reporting process on behalf of the Board, the Company's management is responsible for the preparation, presentation, and integrity of the Company's financial statements and for the appropriateness of the accounting principles and reporting policies used by the Company. The independent auditor is responsible for auditing the Company's annual financial statements and for reviewing the Company's unaudited interim financial statements filed with the SEC.

B.

Audit Committee Report. The Committee shall prepare a report to shareholders as required by the SEC to be included in the Company's annual proxy statement.

C.

Plan Activities. The Committee shall have oversight responsibility for the activities of the Company relative to the W.W. Grainger, Inc. Employees Profit Sharing Plan and Trust and other ERISA plans/trusts sponsored by the Company and/or any of its subsidiaries that involve the investment of funds by fiduciaries for the benefit of employees (collectively, "Company Plans").

D.

Resources and Authority. The Committee shall be given the appropriate resources and assistance necessary to discharge its responsibilities. The Committee shall also have the authority to engage outside legal, accounting, and other advisors as it determines necessary to carry out its duties.

II. Specific Responsibilities of the Committee

A.

Independent Auditor. The Committee shall be directly responsible for the appointment, compensation, retention, evaluation, termination, and oversight of the work of the Company's independent auditor for the purpose of preparing or issuing an audit report or performing other audit, review or attest services or related work for the Company, including the resolution of disagreements between management and the independent auditor. The Company's independent auditor must report directly to the Committee, and the Committee shall have the sole authority to retain and replace the Company's independent auditor and shall pre-approve all audit and non-audit services and fees of the independent auditor. The Committee may delegate pre-approval authority to one or more members of the Committee as long as any such decisions by any member to whom authority is delegated are presented to the full Committee at its next scheduled meeting.

B.

Complaint Procedures. The Committee shall establish procedures for the receipt, retention, and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.

C.

Independent Auditor Evaluation. The Committee shall, at least annually, obtain and review a report by the independent auditor describing:

1. The firm's internal quality control procedures;

2. Any material issues raised by the most recent internal quality control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and

3. All relationships between the independent auditor and the Company.

Based on such review and the independent auditor's work throughout the year, the Committee shall evaluate the independent auditor's qualifications, performance, and independence, taking into account the opinions of management and the Company's internal auditors.

D.

Independent Auditor Plans and Activities. The Committee shall review the independent auditor's plan and scope of activities, including any areas to which either the Committee, the internal auditors, or the independent auditor believe special attention should be directed. In addition, the Committee shall regularly review with the independent auditor any audit problems or difficulties and management's response.

E.

Annual Financial Information. The Committee shall review with management and the independent auditor the audited financial statements to be included in the Company's Annual Report on Form 10-K, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations." The Committee shall review and consider with the independent auditor the matters required to be discussed by Statement of Auditing Standards No. 61 ("SAS No. 61"). Also, the Committee shall discuss the results of the annual audit, giving special attention to the following:

1. Adequacy of internal controls;

2. Unusual, improper, or illegal transactions;

3. Change in accounting, legal, or other regulatory requirements which will or could significantly affect the Company;

4. All proposed adjustments of the independent auditor not recorded by the Company;

5. Any significant differences in the interpretation of Generally Accepted Accounting Principles (GAAP) between the Company and the independent auditor, as well as any areas where alternative applications of GAAP could have a material effect on the financial statements; and

6. Any significant financial risks facing the Company.

The Committee shall make a determination whether to recommend to the Board that the audited financial statements be included in the Company's Form 10-K.

F. *Critical Accounting Policies.* The Committee shall receive a report from the independent auditor, prior to the filing of its audit report with the SEC, on all critical accounting policies and practices used by the Company, all material alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the independent auditor, and other material written communications between the independent auditor and management.

G. *Officer Certifications.* The Committee shall review with the Company's Chief Executive Officer and Chief Financial Officer compliance with those officers' certification obligations in connection with the Company's quarterly and annual reports prior to the filing thereof.

H. *Internal Controls and Disclosure Controls.* The Committee shall review with management the Company's disclosure controls and procedures and internal control over financial reporting, and make recommendations to the Board of any changes considered appropriate.

I. *Interim Financial Information.* The Committee shall review with management and the independent auditor the Company's interim financial statements to be included on Form 10-Q, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations." This review shall occur prior to the Company's filing of Form 10-Q with the SEC. Also, the Committee shall discuss with the independent auditor the results of the quarterly review and any other matters required to be communicated to the Committee by the independent auditor under generally accepted auditing standards.

J. *Earnings Releases and Guidance.* The Committee shall discuss with management earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies. Discussions may be done generally, such as the types of information to be disclosed and the type of presentation to be made.

K. *Risk Management Policies.* The Committee shall discuss with management the Company's major financial risk exposures, the steps management has taken to monitor and control such exposures, and the Company's risk assessment and risk management policies and guidelines.

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L. *Separate Meetings.* The Committee shall meet separately and periodically, but no less than four times each year, with management, the Company's internal auditors, and the independent auditor with regard to the adequacy of internal accounting controls and any other matters they believe should be discussed privately.

M. *Internal Auditor Resources and Activities.* The Committee shall review, with the Company's internal auditors, its budget and staffing, audit plan, responsibilities, the examinations completed from time to time, including responses by management, and any areas to which either the Committee or the internal auditors believe additional or special attention should be directed.

N. *Independent Auditor Employees.* The Committee shall approve and periodically review the Company's hiring policies for employees or former employees of the independent auditor. The Company's current policy prohibits the hiring of any current or previous employees of its independent auditor who have worked on the Company's account within the past two years.

O. *Legal Issues.* The Committee shall review, at least annually, significant legal and regulatory issues with the Company's counsel.

P. *Business Conduct Guidelines.* The Committee shall review and monitor the Company's compliance with its Business Conduct Guidelines.

Q. *Company Plan Assets.* The Committee shall review and make recommendations to the Board of Directors concerning:

1. Amendments or other proposals relative to Company Plans that involve investment of assets, appointment of trustees and investment managers, and other matters relative to management of the assets of Company Plans, subject to coordination with the Compensation Committee of the Board where appropriate; and

2. Appointment of members of the Profit Sharing Trust Committee.

R. *Company Plan Investments.* The Committee shall review on a periodic basis and report to the Board of Directors at least annually, concerning:

1. The allocation of assets of Company Plans among various asset classes (e.g., domestic stocks, international stocks, short-term bonds, long-term bonds, etc.);

2. The investment performance of the assets of Company Plans, including performance comparisons with appropriate benchmarks;

3. Investment guidelines and other matters of investment policy relative to Company Plans; and

4. The hiring, dismissal, or retention of investment managers.

III. Committee Operations

A. *Committee Meetings.* The Committee shall meet at least four times a year and on call of the Committee Chairman as needed to discharge the general and specific responsibilities enumerated above.

B. *Subcommittees.* The Committee may delegate authority to one or more subcommittees.

C. *Committee Reporting.* The Committee shall make regular reports to the Board.

D.

Committee Evaluation. The Committee shall annually review its own performance.

E.

Charter Review. The Committee shall annually review its charter and recommend any proposed amendments to the Board.

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WWG-PS-04

W.W. GRAINGER, INC.

C/O EQUISERVE TRUST COMPANY, N.A.
P.O. BOX 8694
EDISON, NJ 08818-8694

Your vote is important. Please vote immediately.

Vote-by-Internet		**Vote-by-Telephone**
Log on to the Internet and go to	**OR**	**Call toll-free**
http://www.eproxyvote.com/gww		**1-877-PRX-VOTE (1-877-779-8683)**

If you vote over the Internet or by telephone, please do not mail your card.

DETACH HERE IF YOU ARE RETURNING YOUR PROXY CARD BY MAIL ZWWGC1

#WWG

ý **Please mark votes as in this example.**

MANAGEMENT RECOMMENDS A VOTE "FOR" ITEMS 1 AND 2.

1. Election of Directors.

Nominees: (01) Brian P. Anderson, (02) Wesley M. Clark, (03) Wilbur H. Gantz, (04) David W. Grainger, (05) Richard L. Keyser, (06) Frederick A. Krehbiel, (07) John W. McCarter, Jr., (08) Neil S. Novich, (09) James D. Slavik, (10) Harold B. Smith, (11) Janiece S. Webb

FOR ALL NOMINEES o **WITHHOLD FROM ALL NOMINEES** o

o ______________________________

For all nominees except as noted above

	FOR	AGAINST	ABSTAIN
2. Proposal to ratify the appointment of Grant Thornton LLP as independent auditors for the year ending December 31, 2004.	o	o	o

3. In their discretion upon such other matters as may properly come before the meeting.

MARK HERE FOR ADDRESS CHANGE AND NOTE AT LEFT o

MARK HERE IF YOU PLAN TO ATTEND THE MEETING o

Please sign exactly as your name or names appear hereon. Joint owners should each sign personally. If signing in a fiduciary or representative capacity, give full title as such.

Signature:		Date:		Signature:		Date:	
	________		____		________		____

DETACH HERE IF YOU ARE RETURNING YOUR PROXY CARD BY MAIL

ZWWGC2

COMMON PROXY

COMMON PROXY

W.W. GRAINGER, INC.

100 Grainger Parkway, Lake Forest, Illinois 60045-5201

SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS

Proxy for Annual Meeting of Shareholders, April 28, 2004

The undersigned hereby appoints Wesley M. Clark, David W. Grainger, and Richard L. Keyser, and each of them, proxies of the undersigned with full power of substitution to represent the undersigned and to vote all of the shares of the Common Stock of W.W. Grainger, Inc. which the undersigned is entitled to vote at the Annual Meeting of Shareholders of W.W. Grainger, Inc. to be held on April 28, 2004 and at any and all adjournments thereof, with all the powers the undersigned would possess if personally present and voting thereat.

A majority of said proxies or substitutes who shall be present at the meeting may exercise all powers hereunder. All proxies will be voted as specified. **If no specification is made, the proxy will be voted FOR items 1 and 2. If authority is given to vote for the election of directors, this proxy may be voted cumulatively for directors as set forth in the proxy statement.**

SEE REVERSE SIDE

CONTINUED, AND TO BE SIGNED AND DATED, ON REVERSE SIDE

SEE REVERSE SIDE

QuickLinks

pace:nowrap;">

70,321

66,279

Cost of revenue:

Software

16,760

15,965

47,189

43,087

Service

3,812

4,238

11,369

12,683

Total cost of revenue

20,572

20,203

58,558

55,770

Gross profit

3,963

3,369

11,763

10,509

Operating expenses:

Selling, general and administrative

2,880

3,960

9,352

11,432

Research and development

360

804

1,215

2,205

Total operating expenses

3,240

4,764

10,567

13,637

Income (loss) from operations

723

(1,395

)

1,196

(3,128

)

Other income (expense), net

(16

)

(15

)

(118

)

100

Income (loss) before income taxes

707

(1,410

)

1,078

(3,028

)

Income tax expense

(16

)

(2,157

)

(129

)

(2,206

)

Net income (loss)

$

691

$

(3,567

)

$

949

$

(5,234

)

Basic income (loss) per share

$

0.06

$

(0.32
)
$
0.08
$
(0.47
)
Diluted income (loss) per share
$
0.06
$
(0.32
)
$
0.08
$
(0.47
)

Shares used in calculation of income (loss) per share:

Basic

11,655

11,194

11,520

11,150

Diluted

11,832

11,194

11,732

11,150

Comprehensive income (loss):

Net income (loss)

$

691

$

(3,567

)

$

949

$

(5,234

)

Other comprehensive income (expense):

Foreign currency translation, net of tax

(97

)

56

34

(35

)

Change in unrealized gains on investments, net

of tax

—

1

—

(2

)

Total other comprehensive income (expense)

(97

)

57

34

(37

)

Comprehensive income (loss)

$

594

$

(3,510

)

$

983

$

(5,271

)

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income (loss)	$949	$(5,234)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Realized loss on disposal of assets	33	—
Depreciation and amortization	479	586
Stock-based compensation	691	726
Deferred income taxes	—	2,181
Changes in operating assets and liabilities:		
Accounts receivable, net	4,144	3,284
Prepaid expenses and other assets	1,871	(418)
Third-party software fees payable	(2,805)	(44)
Accounts payable and accrued expenses	(645)	(394)
Deferred revenue	(673)	237
Deferred rent	20	268
Net cash provided by operating activities	4,064	1,192
Cash flows from investing activities:		
Purchases of equipment and furniture	(276)	(216)
Proceeds from maturities of short-term investments	9,195	8,932
Purchases of short-term investments	(14,547)	(7,163)
Reduction of restricted cash	—	625
Net cash provided by (used in) investing activities	(5,628)	2,178
Cash flows provided by financing activities—proceeds from exercise of stock options	595	12
Effect of exchange rate changes on cash	34	(49)
Net increase (decrease) in cash and cash equivalents	(935)	3,333
Cash and cash equivalents, beginning of period	13,510	9,903
Cash and cash equivalents, end of period	$12,575	$13,236

Nine Months Ended

	September 30,	
	2014	2013
Supplemental disclosure of cash flow information:		
Non-cash investing activity-leasehold improvements & furniture funded by landlord	$1,128	$—

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of BSQUARE Corporation (“BSQUARE”) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting and include the accounts of BSQUARE and our wholly owned subsidiaries. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of September 30, 2014 and our operating results and cash flows for the three and nine months ended September 30, 2014 and 2013. The accompanying financial information as of December 31, 2013 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2013. All intercompany balances have been eliminated.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued an Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers”, amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The guidance is effective for annual and interim reporting periods beginning after December 15, 2016, with early adoption prohibited. We are currently evaluating the impact this ASU will have on our consolidated financial statements.

In August 2014 the FASB issued ASU No. 2014-15, Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern, requiring management to evaluate whether there is a substantial doubt about an entity’s ability to continue as a going concern and to provide related disclosures in the notes to the financial statements. The new guidance reduces diversity in the timing and content of disclosures from current guidance, and is effective for annual and interim reporting periods beginning after December 15, 2015 with early adoption permitted. We do not expect the adoption of this guidance to have a material effect on our consolidated financial statements.

Income (Loss) Per Share

Basic income or loss per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as options, restricted stock awards and restricted stock units. Restricted stock awards (“RSAs”) are considered outstanding and included in the computation of basic income or loss per share when underlying restrictions expire and the awards are no longer forfeitable. Restricted stock units (“RSUs”) are considered outstanding and included in the computation of basic income or loss per share only when vested. Diluted income per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock method. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive.

We excluded an aggregate of 882,490 and 868,767options and RSUs for the three and nine months ended September 30, 2014, respectively, from diluted earnings per share because their effect was anti-dilutive. We excluded an aggregate of 940,812 and 837,812 options and RSUs for the three and nine months ended September 30, 2013, respectively, from diluted earnings per share because their effect was anti-dilutive. In a period where we are in a net loss position, diluted loss per share is computed using the basic share count.

2. Cash and Investments

Cash, cash equivalents, short-term investments, and restricted cash consisted of the following at September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014	December 31, 2013
Cash	$ 2,718	$ 2,521
Cash equivalents:		
Money market funds	8,356	8,989
Corporate commercial paper	1,250	—
Corporate debt securities	251	2,000
Total cash equivalents	9,857	10,989
Total cash and cash equivalents	12,575	13,510
Short-term investments:		
Corporate commercial paper	1,199	1,500
Foreign government bonds	—	1,001
Corporate debt securities	11,447	4,794
Total short-term investments	12,646	7,295
Restricted cash—money market fund	250	250
Total cash, cash equivalents, investments and restricted cash	$ 25,471	$ 21,055

Gross unrealized gains and losses on our short-term investments were not material as of September 30, 2014 and December 31, 2013. Our restricted cash balance at September 30, 2014 and December 31, 2013 relates to a letter of credit which secures our corporate headquarters lease.

3. Fair Value Measurements

We measure our cash equivalents and short-term investments at fair value. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. A three-tier fair value hierarchy is established as a basis for considering such assumptions and for inputs used in the valuation methodologies in measuring fair value:

Level 1: Quoted prices in active markets for identical assets or liabilities.
Level 2: Directly or indirectly observable market-based inputs or unobservable inputs used in models or other valuation methodologies.
Level 3: Unobservable inputs that are not corroborated by market data. The inputs require significant management judgment or estimation.

We classify our cash equivalents and short-term investments within Level 1 or Level 2 because our cash equivalents and short-term investments are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs.

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Assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013 are summarized below (in thousands):

	September 30, 2014		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Total
Assets			
Cash equivalents:			
Money market funds	$8,356	$ —	$8,356
Corporate commercial paper	—	1,250	1,250
Corporate debt	—	251	251
Total cash equivalents	8,356	1,501	9,857
Short-term investments:			
Corporate commercial paper	—	1,199	1,199
Corporate debt	—	11,447	11,447
Total short-term investments	—	12,646	12,646
Restricted cash—money market fund	250	—	250
Total assets measured at fair value	$8,606	$ 14,147	$22,753

	December 31, 2013		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Total
Assets			
Cash equivalents:			

Money market funds	$8,989	$ —	$8,989
Corporate debt	—	2,000	2,000
Total cash equivalents	8,989	2,000	10,989
Short-term investments:			
Corporate commercial paper	—	1,500	1,500
Foreign government bonds	—	1,001	1,001
Corporate debt	—	4,794	4,794
Total short-term investments	—	7,295	7,295
Restricted cash—money market fund	250	—	250
Total assets measured at fair value	$9,239	$ 9,295	$18,534

4. Goodwill and Intangible Assets

Goodwill relates to the 2011 acquisition of MPC Data, Ltd. ("MPC"), a United Kingdom based provider of embedded software engineering services. The excess of the acquisition consideration over the fair value of net assets acquired was recorded as goodwill. We operate as a single reporting unit, and MPC falls within that reporting unit. There was no change in the carrying amount of goodwill during the nine months ended September 30, 2014.

Intangible assets relate to customer relationships that we acquired from TestQuest Inc. in 2008 and from the acquisition of MPC in 2011, the vast majority of which relates to the MPC acquisition.

Information regarding our intangible assets as of September 30, 2014 and December 31, 2013 is as follows (in thousands):

	September 30, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Customer relationships	1,275	(513)	762

	December 31, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Customer relationships	1,275	(412)	863

Amortization expense was $34,000 and $101,000 for the three and nine months ended September 30, 2014, respectively, and $56,000 and $172,000 for the three and nine months ended September 30, 2013, respectively. Amortization in future periods is expected to be as follows (in thousands):

Remainder of 2014	$34
2015	135
2016	130
2017	98
2018	98
Thereafter	267
Total	$762

5. Shareholders’ Equity

Equity Compensation Plans

We have a stock plan (the “Stock Plan”) and an inducement stock plan for newly hired employees (the “Inducement Plan”) (collectively, the “Plans”). Under the Plans, stock options may be granted with a fixed exercise price that is equivalent to fair market value on the date of grant. These options have a term of up to 10 years and vest over a predetermined period, generally four years. Incentive stock options granted under the Stock Plan may only be granted to our employees. The Plans also allow for awards of non-qualified stock options, stock appreciation rights, RSAs and unrestricted stock awards, and RSUs.

Stock-Based Compensation

The estimated fair value of stock-based awards is recognized as compensation expense over the vesting period of the award, net of estimated forfeitures. We estimate forfeitures based on historical experience and expected future activity. The fair value of RSAs and RSUs is determined based on the number of shares granted and the quoted price of our common stock on the date of grant. The fair value of stock option awards is estimated at the grant date based on the fair value of each vesting tranche as calculated by the Black-Scholes-Merton ("BSM") option-pricing model. The BSM model requires various highly judgmental assumptions including expected volatility and option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. The fair values of our stock option grants were estimated with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Dividend yield	0 %	0 %	0 %	0 %
Expected life	3.3 years	4 years	3.3 years	4 years
Expected volatility	57 %	58 %	59 %	62 %
Risk-free interest rate	1.4 %	1.1 %	1.3 %	0.8 %

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The impact on our results of operations of stock-based compensation expense for the three and nine months ended September 30, 2014 and 2013 was as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Cost of revenue — service	$69	$48	$146	$184
Selling, general and administrative	144	145	510	456
Research and development	15	27	35	86
Total stock-based compensation expense	$228	$220	$691	$726
Per diluted share	$0.02	$0.02	$0.06	$0.07

Stock Option Activity

The following table summarizes stock option activity under the Plans for the nine months ended September 30, 2014:

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Balance at January 1, 2014	1,515,621	$ 3.36		
Granted	740,458	3.48		
Exercised	(374,565)	2.49		
Forfeited	(96,531)	3.27		
Expired	(258,671)	4.34		
Balance at September 30, 2014	1,526,312	$ 3.48	6.91	$954,646
Vested and expected to vest at September 30, 2014	1,407,188	$ 3.48	6.73	$900,866
Exercisable at September 30, 2014	593,423	$ 3.50	3.90	$498,217

At September 30, 2014, total compensation cost related to stock options granted but not yet recognized was $923,055, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.3 years. The following table summarizes certain information about stock options for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Weighted-average grant-date fair value of option grants for the period	$1.74	$—	$1.71	1.07
Options in-the-money at period end	425,877	541,000	425,877	541,000
Aggregate intrinsic value of options exercised	$171,558	$—	$412,781	$1,000

The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of our common stock for the number of options that were in-the-money at period end or that were exercised during the period. We issue new shares of common stock upon exercise of stock options.

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Restricted Stock Unit Activity

The following table summarizes RSU activity for the nine months ended September 30, 2014:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2013	187,382	$ 4.40
Granted	102,735	3.16
Vested	(132,421)	3.70
Forfeited	(56,732)	5.54
Unvested at September 30, 2014	100,964	$ 3.43
Expected to vest after September 30, 2014	96,371	$ 3.37

At September 30, 2014, total compensation cost related to RSUs granted but not yet recognized was $403,482, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.1 years. There were no RSAs outstanding as of September 30, 2014 or December 31, 2013.

Common Stock Reserved for Future Issuance

The following table summarizes our shares of common stock reserved for future issuance under the Plans:

	September 30, 2014
Stock options outstanding	1,526,312
Restricted stock units outstanding	100,964
Stock awards available for future grant	706,053
Common stock reserved for future issuance	2,333,329

6. Commitments and Contingencies

Lease and rent obligations

Our commitments include obligations outstanding under operating leases, which expire through 2020. We have lease commitments for office space in Bellevue, Washington; San Diego, California; Boston, Massachusetts; Taipei, Taiwan; Tokyo, Japan; and Trowbridge, UK. We also lease office space on a month-to-month basis in Akron, Ohio.

In August 2013, we amended the lease agreement for our Bellevue, Washington headquarters, which was initially scheduled to expire in August 2014, and extended the lease term to May 2020. The amendment to the headquarters lease provided that no cash lease payments were to be made for a seven-month period from June 1, 2013 to December 31, 2013. In conjunction with the amended lease agreement, the landlord provided lease incentives totaling $1,128,000 for leasehold improvements and furniture related to new space in the same building, which were capitalized and are reflected in the deferred rent liability. We are amortizing these assets over the shorter of their economic life or the lease term. We are recognizing rent expense, including the effect of the deferred rent, on a straight-line basis over the lease term.

Rent expense was $281,000 and $918,000 for the three and nine months ended September 30, 2014, respectively, and $402,000 and $1,156,000 for the three and nine months ended September 30, 2013, respectively.

As of September 30, 2014, we had $250,000 pledged as collateral for a bank letter of credit under the terms of our headquarters facility lease. The pledged cash supporting the outstanding letter of credit is classified as restricted cash.

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

Remainder of 2014	$301
2015	1,290
2016	1,304
2017	1,200
2018	1,111
2019	1,038
2020	437
Total commitments	$6,681

Loss Contingencies

From time to time, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business including tax assessments. We defend ourselves vigorously against any such claims. When (i) it is probable that an asset has been impaired or a liability has been incurred and (ii) the amount of the loss can be reasonably estimated, we record the estimated loss. We provide disclosure in the notes to the consolidated financial statements for loss contingencies that do not meet both of these conditions if there is a reasonable possibility that a loss may have been incurred that would be material to the financial statements. Significant judgment is required to determine the probability that a liability has been incurred and whether such liability is reasonably estimable. We base accruals made on the best information available at the time which can be highly subjective. The final outcome of these matters could vary significantly from the amounts included in the accompanying consolidated financial statements.

Volume Pricing Agreements

In conjunction with our activities under our OEM Distribution Agreements (“ODAs”) with Microsoft Corporation (“Microsoft”), as further described in Note 8, we enter into OEM Volume Royalty Pricing (“OVRP”) commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don’t meet the committed minimum unit volumes, we are obligated to pay the difference between the committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather, the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all significant instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. However, in the event a customer is unwilling or unable to pay us, we would be negatively impacted. Based upon the credit-worthiness of our customers, our historical OVRP experience with our customers and OVRP arrangements in general, we do not believe we will incur any material liability relating to active agreements and, therefore, no provision or reserve has been recorded as of September 30, 2014.

7. Information about Geographic Areas

Our chief operating decision-makers (i.e., Chief Executive Officer and certain direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable by our chief operating decision-makers, or anyone else, for operations, operating results, or planning for levels or components below the consolidated unit level. Accordingly, we consider ourselves to be in a single reporting segment and operating unit structure.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Total revenue:				
North America	$22,456	$20,875	$62,955	$59,714
Asia	830	1,379	3,581	3,129
Europe	1,249	1,318	3,785	3,436
Total revenue	$24,535	$23,572	$70,321	$66,279

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	September 30, 2014	December 31, 2013
Long-lived assets:		
North America	$ 1,669	$ 678
Asia	365	403
Europe	4,480	4,544
Total long-lived assets	$ 6,514	$ 5,625

8. Significant Risk Concentrations

Significant Customer

One customer, Future Electronics, Inc., accounted for 18% and 11% of total revenue for the three and nine months ended September 30, 2014, respectively. No other customers accounted for more than 10% of total revenue for the three or nine months ended September 30, 2014 or September 30, 2013.

No customer had an accounts receivable balance which was 10% or more of the total accounts receivable at September 30, 2014. Future Electronics, Inc. had an accounts receivable balance of $3.7 million, or 23% of total accounts receivable, as of December 31, 2013, all of which was subsequently collected, and Mitsubishi Electric Corporation had an accounts receivable balance of $2.8 million, or 18% of total accounts receivable, as of December 31, 2013, all of which was subsequently collected. No other customer accounted for 10% or more of total accounts receivable at December 31, 2013.

Significant Supplier

We have two ODAs with Microsoft which enable us to sell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, Argentina, Brazil, Chile, Columbia, Mexico, Peru, Puerto Rico, the Caribbean, the European Union, the European Free Trade Association, Turkey and Africa, which expire on June 30, 2016. We also have four ODAs with Microsoft which allow us to sell Microsoft Windows Mobile operating systems in the Americas (excluding Cuba), Japan, Taiwan, Europe, the Middle East, and Africa, which expire on June 30, 2015.

Software sales under these agreements constitute a significant portion of our software revenue and total revenue. These agreements are typically renewed bi-annually, annually or semi-annually; however, there is no automatic renewal provision in any of these agreements. Further, these agreements can be terminated unilaterally by Microsoft at any time. Microsoft currently offers a rebate program to sell Microsoft Windows Embedded operating systems pursuant to which we earn money for achieving certain predefined objectives. Prior to the third quarter of 2013, the entire earned rebate amount was treated as a reduction in software cost of sales in the quarter earned. Beginning in the third quarter of 2013, as a result of program modifications, we began treating a portion of the rebate as marketing development funds which are accounted for as a reduction in marketing expense if and when qualified program expenditures are made. Under this rebate program, we recognized $64,000 and $233,000 during the three and nine months ended September 30, 2014, respectively, and $89,000 and $658,000 during the three and nine months ended

September 30, 2013, respectively, which was treated as a reduction in cost of sales. Additionally, during the three and nine months ended September 30, 2014, we qualified for $149,000 and $543,000, respectively, in rebate credits which will be accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

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

As used in this Quarterly Report on Form 10-Q, “we,” “us,” “our” and “the Company” refer to BSQUARE Corporation, a Washington corporation, and its subsidiaries.

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our condensed consolidated financial statements and related notes. Some statements and information contained in this Management’s Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). In some cases, readers can identify forward- looking statements by terms such as “may,” “will,” “should,” “expect,” “plan,” “intend,” “forecast,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “continue,” or the negative of or other comparable terminology, which when used are meant to signify the statement as forward-looking. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and situations that are difficult to predict and that may cause our own, or our industry’s actual results, to be materially different from the future results that are expressed or implied by these statements. Accordingly, actual results may differ materially from those anticipated or expressed in such statements as a result of a variety of factors, including those discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2013 entitled “Risk Factors,” similar discussions in subsequently filed Quarterly Reports on Form 10-Q, including this Form 10-Q, as applicable, and those contained from time to time in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

Overview

We provide software solutions to companies that develop smart, connected systems. A smart, connected system is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® CE or Google Android) and is usually connected to a network or data cloud via a wired or wireless connection. A smart, connected system also includes the applications and other software that run on or connects to the device. Examples of smart, connected systems include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, tablets, handheld data collection devices, personal media players, smart phones and in-vehicle telematics and entertainment devices. We focus on smart, connected systems that run various Microsoft Windows Embedded and Windows Mobile operating systems, specifically Windows Embedded Compact, Windows Embedded Standard 7 and 8, Windows Mobile™, Windows Phone 8 and Windows Embedded 8 Handheld as well as devices running other popular operating systems such as Android, Linux, and QNX.

We have been providing software solutions to the smart, connected systems marketplace since our inception. Our customers include world class original equipment manufacturers (“OEMs”), original design manufacturers (“ODMs”) and enterprises, as well as silicon vendors and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales to the aforementioned customer categories. In the case of enterprises, our customers include those who develop, market and distribute smart devices on their own behalf as well as those that purchase devices from OEMs or ODMs and require additional device software or testing. The software solutions we provide are utilized and deployed throughout various phases of our customers’ device life cycle, including design, development, customization, quality assurance and deployment.

Critical Accounting Judgments

Management’s discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales, cost of sales and expenses and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There have been no significant changes to our critical accounting judgments, policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2013.

Results of Operations

The following table presents certain financial data as a percentage of total revenue for the periods indicated. Our historical operating results are not necessarily indicative of the results for any future period.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
Revenue:				
Software	81 %	78 %	79 %	78 %
Service	19 %	22 %	21 %	22 %
Total revenue	100 %	100 %	100 %	100 %
Cost of revenue:				
Software	68 %	68 %	67 %	65 %
Service	16 %	18 %	16 %	19 %
Total cost of revenue	84 %	86 %	83 %	84 %
Gross profit	16 %	14 %	17 %	16 %
Operating expenses:				
Selling, general and administrative	12 %	17 %	13 %	18 %
Research and development	1 %	3 %	2 %	3 %
Total operating expenses	13 %	20 %	15 %	21 %
Income (loss) from operations	3 %	(6)%	2 %	(5)%
Other income (expense), net	0 %	0 %	(1)%	0 %
Income (loss) before income taxes	3 %	(6)%	1 %	(5)%
Income tax expense	0 %	(9)%	0 %	(3)%
Net income (loss)	3 %	(15)%	1 %	(8)%

Revenue

Our revenue is generated from the sale of software, primarily third-party software that we resell and our own proprietary software, and the sale of engineering services. Total revenue increased $963,000, or 4%, to $24.5 million for the three months ended September 30, 2014, from $23.6 million in the year-ago period. Total revenue increased $4.0 million, or 6%, to $70.3 million for the nine months ended September 30, 2014, from $66.3 million in the year-ago period. Both of the increases were driven by higher third-party software sales.

Revenue from customers outside of North America decreased $0.6 million, or 23%, to $2.1 million for the three months ended September 30, 2014 compared to $2.7 million in the year-ago period. Revenue from customers outside of North America increased $0.8 million, or 12%, to $7.4 million for the nine months ended September 30, 2014 compared to $6.6 million in the year-ago period. The increase in the nine-month period was primarily driven by higher service revenue in Japan which, in turn, was driven by two large handheld terminal projects. The decrease in the three-month period is due to the timing of engineering services on the Japan projects.

Software revenue

Software revenue consists of sales of third-party software and revenue realized from our own proprietary software products, which include software license sales, royalties from our software products, and support and maintenance revenue. Software revenue for the three and nine months ended September 30, 2014 and 2013 was as follows (dollars in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
Software revenue:				
Third-party software	$19,217	$18,004	$53,877	$49,749
Proprietary software	551	452	1,754	2,069
Total software revenue	$19,768	$18,456	$55,631	$51,818
Software revenue as a percentage of total revenue	81 %	78 %	79 %	78 %
Third-party software revenue as a percentage of total software revenue	97 %	98 %	97 %	96 %

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The vast majority of our third-party software revenue is comprised of sales of Microsoft Windows Embedded and Windows Mobile operating systems.

Third-party software revenue increased $1.2 million, or 7%, for the three months ended September 30, 2014, from the year-ago period. The improvement was driven by a $2.9 million increase in sales of Windows Mobile operating systems driven by sales to two existing customers and was partially offset by a $1.0 million decrease in Windows Embedded operating system sales that resulted from the timing of sales to existing customers. Third-party software revenue increased $4.1 million, or 8%, for the nine months ended September 30, 2014, compared to the year-ago period. The increase was driven by a $5.5 million increase in Windows Embedded operating system sales, partially offset by a $1.1 million decrease in Adobe Flash sales. Revenue in the nine months ended September 30, 2014 further benefited from a significant sale of Windows Embedded operating systems in the amount of $2.6 million to a single customer in the first quarter of 2014.

Proprietary software revenue increased $99,000, or 22%, to $551,000 for the three months ended September 30, 2014, from $452,000 in the year-ago period, primarily driven by increases in sales of a number of our legacy products.

Proprietary software revenue decreased $315,000, or 15%, for the nine months ended September 30, 2014, compared to the year-ago period, driven primarily by a decline in Texas Instruments OMAP royalty revenue as well as declines in sales of a number of our legacy products.

Service revenue

Service revenue for the three and nine months ended September 30, 2014 and 2013 was as follows (dollars in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
Service revenue	$4,767	$5,116	$14,690	$14,461
Service revenue as a percentage of total revenue	19 %	22 %	21 %	22 %

Service revenue decreased $349,000, or 7%, for the three months ended September 30, 2014, from the year-ago period. This decrease was driven by lower revenue associated with the MyFord Touch program. The decrease was partially offset by small increases in service revenue in both the United Kingdom and Asia.

Service revenue increased $229,000, or 2%, for the nine months ended September 30, 2014, compared to the year-ago period. The improvement was driven by a $1.5 million increase in Japan which benefited from two large handheld terminal projects as well as small increases in the United Kingdom and other regions in Asia. During the nine months ended September 30, 2014, we completed one of the projects in Japan which resulted in the recognition of $478,000 in service revenue and gross profit during the three months ended June 30, 2014. Both programs are being accounted for under the zero profit percentage of completion accounting method in which we recognize revenue during the project equal to our cost and recognize the remaining revenue, equal to the gross profit on the program, at completion. There were no such completions in the three months ended September 30, 2014. The increase was offset by a $1.5 million decline in North America service revenue which, in turn, was driven by lower revenue on the MyFord Touch program.

We continued to work on the MyFord Touch program during the three months ended September 30, 2014, a project we began with Ford during the second quarter of 2008 and which has been significant for us since its inception. We now perform these services through agreements with Microsoft and another customer. Service revenue from the MyFord Touch program was $655,000 and $1.2 million for the three months ended September 30, 2014 and 2013, respectively, and $2.1 million and $3.7 million for the nine months ended September 30, 2014 and 2013, respectively. These declines are primarily attributable to a reduction in the number of engineers working on the MyFord Touch project.

Gross profit and gross margin

Cost of software revenue consists primarily of the cost of third-party software products payable to third-party vendors and support costs associated with our proprietary software products. Cost of service revenue consists primarily of salaries and benefits, contractor costs and re-billable expenses, related facilities and depreciation costs, and amortization of certain intangible assets related to acquisitions. Gross profit on the sale of third-party software products is also positively affected by rebate credits we receive from Microsoft for the sale of Windows Embedded operating systems earned through the achievement of defined objectives. Prior to the third quarter of 2013, the entire earned rebate amount was treated as a reduction of software cost of sales in the quarter earned. Beginning in the third quarter of 2013, as a result of program modifications, we began treating a portion of the rebate as marketing development funds which are accounted for as a reduction of marketing expense if and when qualified program expenditures are made. Under this rebate program, we recognized $64,000 and $233,000, respectively, during the three and nine months ended September 30, 2014 and $89,000 and $658,000, respectively, during the three and nine months ended September 30, 2013, which was treated as a reduction in cost of sales. Additionally, during the three and nine months ended September 30, 2014, we qualified for $149,000 and $543,000, respectively, in rebate credits which will be accounted for as a reduction in marketing expense if and when qualified program expenditures are made.

Gross profit and related gross margin for the three and nine months ended September 30, 2014 and 2013 were as follows (dollars in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
Software gross profit	$3,008	$2,491	$8,442	$8,731
Software gross margin	15 %	13 %	15 %	17 %
Service gross profit	$955	$878	$3,321	$1,778
Service gross margin	20 %	17 %	23 %	12 %
Total gross profit	$3,963	$3,369	$11,763	$10,509
Total gross margin	16 %	14 %	17 %	16 %

Software gross profit and gross margin

Software gross profit increased by $517,000, or 21%, for the three months ended September 30, 2014, from the year-ago period, and software gross margin increased by 2 percentage points to 15% from the year-ago period. The increases in software gross profit and margin were driven by an increase in proprietary software revenue compared to a relatively fixed cost base as well as increased revenue from Windows Mobile operating systems which are a higher margin product. Third-party software gross margin was 14% for the three months ended September 30, 2014, and 13% for the year-ago period, driven by the increased revenue from proprietary software and Windows Mobile operating systems. Proprietary software gross margin was 74% for the three months ended September 30, 2014, compared to 42% in the year-ago period due to the increased revenue on a relatively fixed cost base.

Software gross profit decreased by $289,000, or 3%, for the nine months ended September 30, 2014, from the year-ago period, and software gross margin decreased by 2 percentage points to 15% from the year-ago period. The decrease in software gross profit was driven by a decrease in proprietary software revenue that has a relatively fixed cost base as well as a shift in product mix to lower margin Microsoft Embedded operating systems. Third-party software margin was 13% and 15% for the nine months ended September 30, 2014 and 2013, respectively, with the decline driven by the shift in products to lower margin Microsoft Embedded operating systems. Proprietary software margin was 72% for the nine months ended September 30, 2014, compared to 68% in the year-ago period.

Service gross profit and gross margin

Service gross profit increased by $77,000, or 9%, for the three months ended September 30, 2014, from the year-ago period. Service gross margin increased by 3 percentage points to 20% for the three months ended September 30, 2014, compared to the year-ago period. The increase in service gross profit was driven by a decline in cost of sales made possible by improvement in utilization that resulted largely from headcount reductions that occurred in the fourth quarter of 2013. The gross margin improvement resulted from an increase in our realized rate per hour.

Service gross profit increased $1.5 million, or 87%, for the nine months ended September 30, 2014, from $1.8 million in the year-ago period driven by the same factors that accounted for the three-month increase as well as the impact of recognizing the $478,000 of gross profit on the previously mentioned service project completed in Japan in the second quarter of 2014. Service gross margin increased 11 percentage points to 23% for the nine months ended September 30, 2014, compared to the year-ago period. The margin improvement was driven by a decline in our cost per billable hour resulting from utilization improvement, offset in part by a decline in our realized rate per hour.

Operating expenses

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and related benefits, commissions for our sales teams, marketing and administrative personnel and related facilities and depreciation costs, as well as professional services fees (e.g., consulting, legal, tax and audit). Selling, general and administrative expenses decreased $1.1 million, or 27%, to $2.9 million for the three months ended September 30, 2014, from $4.0 million in the year-ago period. The decrease was driven primarily by lower headcount-related costs resulting from restructuring and other reductions as well as decreased facilities and travel expenses. Selling, general and administrative expenses represented 12% of our total revenue for the three months ended September 30, 2014 and 17% in the year-ago period.

Selling, general and administrative expenses decreased $2.0 million, or 18%, to $9.4 million for the nine months ended September 30, 2014, from $11.4 million in the year-ago period. The decrease was due to the same factors accounting for the decrease for the three-month period. Selling, general and administrative expenses represented 13% of our total revenue for the nine months ended September 30, 2014 and 18% for the year-ago period.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs and related facilities and depreciation costs. Research and development expenses decreased $444,000, or 55%, to $360,000 for the three months ended September 30, 2014, from $804,000 in the year-ago period due primarily to headcount and other expense reductions that took place in the fourth quarter of 2013. Research and development expenses represented 1% of our total revenue for the three months ended September 30, 2014 and 3% in the year-ago period.

Research and development expenses decreased $1.0 million, or 45%, to $1.2 million for the nine months ended September 30, 2014, from $2.2 million in the year-ago period. This decrease was driven by the same factors that accounted for the three-month decrease. Research and development expenses represented 2% of our total revenue for the nine months ended September 30, 2014 and 3% for the year-ago period.

Other income (expense), net

Other income or expense consists of interest income on our cash, cash equivalents and investments, gains and/or losses recognized on our investments, as well as gains or losses on foreign exchange transactions. Other expense increased $1,000 to $16,000 for the three months ended September 30, 2014, compared to the year-ago period, due to foreign currency transaction losses.

Other expense was $118,000 for the nine months ended September 30, 2014, compared to other income of $100,000 for the year-ago period, also as a result of net foreign currency transaction losses and gains, respectively.

Income tax expense

Income tax expense was $16,000 for the three months ended September 30, 2014, compared to $2.2 million in the year-ago period, a decrease of $2.1 million. In the third quarter of 2013, we determined that it was not more likely than not that we would generate sufficient future taxable income to utilize the US deferred tax assets. As a result, we recorded a valuation allowance of $2.2 million at that time with a resulting charge to income tax expense. Deferred tax assets relative to our foreign jurisdictions were already subject to a full valuation allowance.

Income tax expense decreased $2.1 million to $0.1 million for the nine months ended September 30, 2014, compared to $2.2 million in the year-ago period due to the same factors that accounted for the three-month change.

The effective tax rates for the three and nine months ended September 30, 2014 of 2% and 12%, respectively, were lower than the U.S. statutory rate of 34% because of net operating losses available to offset current year taxable income and a full valuation allowance on deferred tax assets. The effective tax rates for the three and nine months ended September 30, 2013 of 153% and 73%, respectively, were higher than the U.S. statutory rate of 34% primarily due to a $2.2 million charge recorded to increase the valuation allowance on deferred tax assets.

Liquidity and Capital Resources

As of September 30, 2014, we had $25.5 million of cash, cash equivalents, short-term and long-term investments and restricted cash, compared to $21.1 million at December 31, 2013.

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Net cash provided by operating activities was $4.1 million for the nine months ended September 30, 2014, driven primarily by net income, positive net working capital changes and non-cash charges. Net cash provided by operating activities was $1.2 million for the nine months ended September 30, 2013, driven by positive net working capital changes and non-cash charges, which were offset in part by our $5.2 million net loss for such period.

Investing activities used cash of $5.6 million for the nine months ended September 30, 2014, due to a net increase in short-term investments of $5.3 million and capital expenditures of $276,000. Investing activities provided cash of $2.2 million for the nine months ended September 30, 2013 due to a $1.8 million reduction in short-term investments and a $625,000 reduction in restricted cash as a result of amending our headquarters lease, offset by capital expenditures of $216,000.

Financing activities generated $595,000 during the nine months ended September 30, 2014, and $12,000 during the nine months ended September 30, 2013, as a result of employees' exercise of stock options.

We believe that our existing cash, cash equivalents and investments will be sufficient to meet our needs for working capital and capital expenditures for at least the next 12 months.

Cash Commitments

We have the following future or potential cash commitments:

Minimum rents payable under operating leases total $301,000 for the remainder of 2014, $1.3 million in 2015 and 2016, $1.2 million in 2017, $1.1 million in 2018, $1.0 million in 2019 and $0.4 million thereafter; and

In conjunction with our activities under our ODAs with Microsoft, we enter OVRP commitments with Microsoft. Under these OVRPs, we are provided with volume pricing on a customer-by-customer basis assuming certain minimum unit volumes are met. The OVRP terms are 12 months. In the event we don't meet the committed minimum unit volumes, we are obligated to pay the difference between the committed per-unit volume rate and the actual per-unit rate we achieved based upon actual units purchased. The OVRP arrangements do not equate to a minimum purchase commitment but rather, the arrangements are a volume pricing arrangement based upon actual volume purchased. In substantially all significant instances, we have reciprocal agreements with our customers such that we will receive per-unit price adjustments, similar to the amounts we would subsequently owe to Microsoft if such OVRP volumes are not met. However, in the event a customer is unwilling or unable to pay us, we would be negatively impacted. Based upon the credit-worthiness of our customers, our historical OVRP experience with our customers and OVRP arrangements in general, we do not believe we will incur any material liability relating to active agreements.

Recently Issued Accounting Standards

See Note 1, "Summary of Significant Accounting Policies" in the Notes to Condensed Consolidated Financial Statements in Item 1.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that the information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Acting Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Our management carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Acting 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 upon this evaluation, our Chief Executive Officer and Acting Principal Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes in our internal controls over financial reporting during the three months ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the risk factors set forth in Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013, and in Part II, Item 1A, “Risk Factors” in our Quarterly Reports on Forms 10-Q for the periods ended March 31 and June 30, 2014.

Item 5. Other Information

Our Board of Directors has authorized Jerry D. Chase, our President and Chief Executive Officer, to also serve as our “Acting Principal Financial Officer” solely in connection with the review, execution and certification of this Quarterly Report on Form 10-Q for the quarter ended September 30, 2014.

Item 6. Exhibits

The exhibits listed in the accompanying Index to Exhibits are filed or incorporated by reference as part of this Quarterly Report on Form 10-Q.

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 13, 2014	By:	/s/ JERRY D. CHASE Jerry D. Chase President, Chief Executive Officer and Acting Principal Financial Officer

BSQUARE CORPORATION

INDEX TO EXHIBITS

Exhibit Number	Description	Filed or Furnished Herewith	Incorporated by Reference Form	Filing Date	Exhibit	File No.
3.1	Amended and Restated Articles of Incorporation		S-1	8/17/1999	3.1 (a)	333-85351
3.1(a)	Articles of Amendment to Amended and Restated Articles of Incorporation		10-Q	8/7/2000	3.1	000-27687
3.1(b)	Articles of Amendment to Amended and Restated Articles of Incorporation		8-K	10/11/2005	3.1	000-27687
3.2	Bylaws and all amendments thereto		10-K	3/19/2003	3.2	000-27687
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934	X				
31.2	Certification of Acting Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934	X				
32.1	Certification of Chief Executive Officer and Acting Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X				
101.INS	XBRL Instance Document	X				
101.SCH	XBRL Taxonomy Extension Schema	X				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	X				
101.DEF	XBRL Taxonomy Extension Definition Linkbase	X				
101.LAB	XBRL Taxonomy Extension Label Linkbase	X				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase	X				