BSQUARE CORP /WA
Form 10-Q
August 12, 2010
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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 June 30, 2010

OR

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

For the transition period from ______ to ______

Commission File Number: 000-27687

BSQUARE CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1650880**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

110 110th Avenue NE, Suite 200,

Bellevue WA	**98004**
(Address of principal executive offices)	**(Zip Code)**

(425) 519-5900

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

The number of shares of common stock outstanding as of July 31, 2010: 10,231,645

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BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended June 30, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	June 30, 2010 (Unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,477	$ 12,918
Short-term investments	7,996	
Accounts receivable, net of allowance for doubtful accounts of $207 at June 30, 2010 and $201 at December 31, 2009	16,781	9,192
Prepaid expenses and other current assets	493	648
Total current assets	32,747	22,758
Long-term investments	843	4,189
Restricted cash	875	900
Equipment, furniture and leasehold improvements, net	676	823
Intangible assets, net	1,256	1,511
Other non-current assets	83	90
Total assets	$ 36,480	$ 30,271
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,124	$ 2,898
Other accrued expenses	6,035	4,058
Accrued compensation	2,091	1,837
Deferred revenue	4,344	3,693
Total current liabilities	17,594	12,486
Deferred rent	276	311
Shareholders equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 10,216,799 shares issued and outstanding at June 30, 2010 and 10,162,589 shares issued and outstanding at December 31, 2009	123,886	123,572
Accumulated other comprehensive loss	(457)	(746)
Accumulated deficit	(104,819)	(105,352)
Total shareholders equity	18,610	17,474
Total liabilities and shareholders equity	$ 36,480	$ 30,271

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts) (Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenue:				
Software	$ 17,246	$ 7,825	$ 29,258	$ 16,123
Service	9,659	8,289	14,592	16,668
Total revenue	26,905	16,114	43,850	32,791
Cost of revenue:				
Software	14,032	5,730	23,677	12,037
Service (1)	5,097	5,979	11,215	11,917
Total cost of revenue	19,129	11,709	34,892	23,954
Gross profit	7,776	4,405	8,958	8,837
Operating expenses:				
Selling, general and administrative (1)	2,981	3,100	6,117	6,395
Research and development (1)	802	921	1,709	2,302
Total operating expenses	3,783	4,021	7,826	8,697
Income from operations	3,993	384	1,132	140
Other income (expense)	(5)	(10)	(493)	104
Income before income taxes	3,988	374	639	244
Income tax benefit (expense)	(15)	(26)	(106)	14
Net income	$ 3,973	$ 348	$ 533	$ 258
Basic income per share	$ 0.39	$ 0.03	$ 0.05	$ 0.03
Diluted income per share	$ 0.39	$ 0.03	$ 0.05	$ 0.03
Shares used in calculation of income per share:				
Basic	10,157	10,110	10,142	10,098
Diluted	10,287	10,191	10,268	10,214

(1) Includes the following amounts related to stock-based compensation expense:

Cost of revenue service	$ 46	$ 68	$ 119	$ 142
Selling, general and administrative	62	128	140	282
Research and development	10	14	19	13
Total stock-based compensation expense	$ 118	$ 210	$ 278	$ 437

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net income	$ 533	$ 258
Adjustments to reconcile net income to net cash used in operating activities:		
Realized loss on investments	546	
Depreciation and amortization	475	483
Stock-based compensation	278	437
Changes in operating assets and liabilities:		
Accounts receivable, net	(7,586)	(3,577)
Prepaid expenses and other assets	163	144
Accounts payable and accrued liabilities	4,457	301
Deferred revenue	650	361
Deferred rent	(35)	14
Net cash used in operating activities	(519)	(1,579)
Cash flows from investing activities:		
Purchases of equipment and furniture	(72)	(100)
Capitalized costs associated with TestQuest acquisition		(43)
Proceeds from maturities of marketable securities	1,000	
Proceeds from sale of auction rate securities	516	175
Purchases of marketable securities	(6,404)	
Other	25	
Net cash provided by (used in) investing activities	(4,935)	32
Cash flows from financing activities - proceeds from exercise of stock options	36	8
Net cash provided by financing activities	36	8
Effect of exchange rate changes on cash	(23)	46
Net decrease in cash and cash equivalents	(5,441)	(1,493)
Cash and cash equivalents, beginning of period	12,918	7,703
Cash and cash equivalents, end of period	$ 7,477	$ 6,210

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2010

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by BSQUARE Corporation (BSQUARE), a Washington corporation, and its subsidiaries (collectively, the Company), pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting and include the accounts of BSQUARE Corporation and its subsidiaries. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly the Company s financial position as of June 30, 2010 and its operating results and cash flows for the three and six months ended June 30, 2010 and 2009. The accompanying financial information as of December 31, 2009 is derived from audited financial statements. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes and estimates of progress on professional engineering service arrangements. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. All intercompany balances have been eliminated.

Recently Issued Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued authoritative guidance on the consolidation of variable interest entities. The new guidance requires a qualitative approach to identifying a controlling financial interest in a variable interest entity (VIE), and requires ongoing assessment of whether an entity is a VIE and whether an interest in a VIE makes the holder the primary beneficiary of the VIE. The Company adopted this guidance on July 1, 2010. Adoption did not have a material impact on our consolidated financial statements.

On January 1, 2010, we prospectively adopted ASU 2009-13, which amends ASC Topic 605, *Revenue Recognition.* Under this standard, we allocate revenue in arrangements with multiple deliverables using estimated selling prices if we do not have vendor-specific objective evidence or third-party evidence of the selling prices of the deliverables. Estimated selling prices are management s best estimates of the prices that we would charge our customers if we were to sell the standalone elements separately. Adoption did not have a material impact on our financial statements.

Income Per Share

Basic income 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 and warrants. Restricted stock awards (RSAs) are considered outstanding and included in the computation of basic income per share when underlying restrictions expire and the awards are no longer forfeitable. Restricted stock units (RSUs), which vest over a period of two to four years, are considered outstanding and included in the computation of basic income 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 and if-converted method in the case of stock options and warrants, respectively. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive. Unvested but outstanding RSU s and RSA s which are forfeitable but outstanding are included in the diluted income per share calculation as well.

2. Investments

The Company s short-term and long-term investments consist of the following (in thousands):

	June 30, 2010		December 31, 2009
Short-term investments:			
Auction rate securities	$	2,592	$
Corporate commercial paper		900	
Corporate notes		1,504	
U.S. agency securities		3,000	
Short-term investments	$	7,996	$

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	June 30, 2010	December 31, 2009
Long-term investments:		
Auction rate securities	$ 843	$ 4,189
Long-term investments	$ 843	$ 4,189
Total investments	$ 8,839	$ 4,189

Auction rate securities (ARS) are securities whose interest or dividend rate was historically reset through a Dutch Auction process, usually every 7, 28 or 35 days. ARS historically trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS were issued and rated as long-term, they were generally priced, traded and classified as short-term instruments because of the interest rate reset mechanism and the ability of the holders to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market. The liquidity of these investments is contingent on redemption of the investments by the issuers, settlement by the underwriters and/or secondary offerors, or sales of the securities in a secondary market.

The Company accounts for certain assets and liabilities at fair value. The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. The Company categorizes each of its fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1: Quoted prices (unadjusted) 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.

Prior to February 2008, the fair value of the Company s ARS approximated par value due to the frequent resets through the auction process. While the ARS continue to earn interest at the maximum contractual rate, there is no active market for these investments, and therefore these investments do not currently have a readily determinable market value.

Due to the lack of observable market quotes on the ARS, the fair value measurements have been estimated using Level 3 inputs. The fair value was based on factors that reflect assumptions market participants would use in pricing, including, among others: secondary market bids on various securities, relevant future market conditions including those that are based on the expected cash flow streams, the underlying financial condition and credit quality of the issuer, and the maturity of the securities, as well as the market activity of similar securities. Based on these inputs, as of June 30, 2010, the Company estimated the fair value of its ARS to be $3.4 million, compared to a par value of $4.3 million.

On March 31, 2010, the Company reached a decision to liquidate its portfolio of ARS. This liquidation will likely occur on the relatively inactive secondary market for ARS where bids can vary greatly within a short time frame and be difficult to predict. In prior periods, it was assumed that the ARS would be held until they were redeemed at full par value by the issuers, or until the underwriters and/or secondary offerors settled. As the Company no longer believes that it will realize full par value from its ARS portfolio, the carrying value of its ARS was adjusted downward by $924,000 as of June 30, 2010, which was deemed to be an other-than-temporary adjustment. Of this amount, $378,000 was deemed to be other than-temporary during 2008, and was recorded as a charge to other income (expense) during that period. The remainder of this amount was deemed to be other-than-temporary during the six months ended June 30, 2010 and was recorded as a $510,000 charge to other income (expense) during the first quarter of 2010, and a $36,000 charge to other income (expense) during the second quarter of 2010.

ARS have generally been classified as long term investments due to the uncertainty as to when these investments will be liquidated, particularly given the secondary market is not particularly active and it is uncertain when the Company can obtain what it believes are reasonable offers on its ARS securities. Subsequent to June 30, 2010, the Company sold ARS holdings with a carrying value of $2.6 million and classified these securities as short-term as of June 30, 2010.

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The following table presents the Company s fair value hierarchy for its financial assets, other than cash, cash equivalents and restricted cash, measured at fair value as of June 30, 2010 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
		(in thousands)		
Auction rate securities:				
Student loan backed	$	$	$ 2,977	$ 2,977
Closed-end funds			336	336
Corporate collateral			122	122
Total auction rate securities			3,435	3,435
Other investments:				
Corporate commercial paper		900		900
Corporate notes		1,504		1,504
US agency securities		3,000		3,000
Total other investments		5,404		5,404
Total investments	$	$ 5,404	$ 3,435	$ 8,839

The following table presents the Company s fair value hierarchy for its financial assets, other than cash, cash equivalents and restricted cash, measured at fair value as of December 31, 2009 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Direct or Indirect Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
		(in thousands)		
Auction rate securities:				
Student loan backed	$	$	$ 3,698	$ 3,698
Closed-end funds			369	369
Corporate collateral			122	122
Total auction rate securities	$	$	$ 4,189	$ 4,189

The following table reconciles the beginning and ending balances for the Company s ARS using significant unobservable inputs (Level 3) (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3):			
	Student Loan Backed	Closed-end Funds	Corporate Collateral	Total
Balance at December 31, 2009	$ 3,698	$ 369	$ 122	$ 4,189

Redemptions at par	(50)			(50)
Sale of securities	(466)			(466)
Reversal of temporary valuation allowance included in accumulated other comprehensive loss	277	31		308
Losses included in earnings	(482)	(64)		(546)
Balance at June 30, 2010	$ 2,977	$ 336	$ 122	$ 3,435

The following table summarizes the Company s available-for-sale securities adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category as of June 30, 2010 (in thousands):

	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate commercial paper	$ 900	$	$	$ 900
Corporate notes	1,504			1,504
US agency securities	3,000			3,000
Balance at June 30, 2010	$ 5,404	$	$	$ 5,404

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The Company held no available-for-sale securities classified as investments as of December 31, 2009. The Company had no net unrealized gains or losses on its investment portfolio as of June 30, 2010. The Company recognized no significant gains or losses during the three and six months ended June 30, 2010 and June 30, 2009 related to such sales, other than those related to its ARS as disclosed above.

3. Intangible Assets

Intangible assets relate to customer relationships, trade names, trademarks and technology acquired from TestQuest, Inc. in November 2008 and from NEC Corporation of America in December 2007. The following table presents the Company s gross carrying value of the acquired intangible assets subject to amortization and accumulated amortization thereof (in thousands):

	June 30, 2010	December 31, 2009
Gross carrying value of the acquired intangible assets subject to amortization	$ 2,158	$ 2,158
Accumulated amortization	(902)	(647)
Net book value	$ 1,256	$ 1,511

As of June 30, 2010, 83% of the gross carrying value and 78% of the net book value represented acquired technology. Amortization expense was $128,000 and $256,000 for the three and six months ended June 30, 2010, respectively, and $125,000 and $257,000 for the three and six months ended June 30, 2009 respectively. Amortization in future periods is expected to be as follows (in thousands):

Remainder of 2010	$ 209
2011	334
2012	330
2013	278
2014	37
Thereafter	68
Total	$ 1,256

4. Stock-Based Compensation

Stock Options

The Company has a stock plan (the Plan) under which stock options may be granted with a fixed exercise price that is typically 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 Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted with an exercise price equal to the fair market value of the Company s stock on the date of grant. The Plan also allows for awards of stock appreciation rights, restricted and unrestricted stock, and restricted stock units. The Plan allows for an automatic annual increase in the number of shares reserved for issuance during each of the Company s fiscal years. Such automatic annual increase is in an amount equal to the lesser of: (i) four percent of the Company s outstanding shares at the end of the previous fiscal year, (ii) an amount determined by the Company s Board of Directors, or (iii) 375,000 shares.

Stock-Based Compensation

The Company records compensation expense associated with stock options and other forms of equity compensation using the straight-line method over the life of each vesting traunch of the awards. Compensation expense includes the impact of an estimate for forfeitures for all awards. The impact on the Company s results of operations of recording stock-based compensation expense for the three and six months ended June 30, 2009 and 2010 was as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Cost of revenue service	$ 46	$ 68	$ 119	$ 142
Selling, general and administrative	62	128	140	282
Research and development	10	14	19	13
Total stock-based compensation expense	$ 118	$ 210	$ 278	$ 437
Per diluted share	$ 0.01	$ 0.02	$ 0.03	$ 0.04

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At June 30, 2010, total compensation cost related to stock options granted under the Plan but not yet recognized was $492,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.4 years and will be adjusted for changes in forfeiture rates.

At June 30, 2010, total compensation cost related to restricted stock awards granted under the Plan but not yet recognized was $55,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately six months.

At June 30, 2010, total compensation cost related to restricted stock units granted under the Plan but not yet recognized was $140,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a period of approximately 1.3 years.

Key Assumptions

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	72%	73%	71%	72%
Risk-free interest rate	1.8%	1.9%	1.9%	1.7%

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

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

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

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

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

Stock Option Activity

The following table summarizes stock option activity under the Plan for the six months ended June 30, 2010:

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2010	2,171,470	$ 3.83		
Granted at fair value	95,275	2.43		
Exercised	(16,307)	2.14		

Forfeited	(74,606)		3.55			
Expired	(122,964)		6.58			
Outstanding at June 30, 2010	2,052,868	$	3.62	5.14	$	28,000
Vested and expected to vest at June 30, 2010	1,959,693	$	3.66	5.07	$	27,000
Exercisable at June 30, 2010	1,581,646	$	3.79	4.78	$	24,000

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The aggregate intrinsic value represents the difference between the exercise price of the underlying options and the quoted price of the Company s common stock for the number of options that were in-the-money at June 30, 2010. The Company issues new shares of common stock upon exercise of stock options.

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Weighted-average grant-date fair value of option grants for the period	$ 1.62	$ 1.30	$ 1.60	1.23
Options in-the-money at period end	249,164	677,324	249,164	677,324
Aggregate intrinsic value of options exercised	$ 5,000	$	$ 7,000	$ 1,000

Restricted Stock Activity

The following table summarizes restricted stock award activity under the Plan for the six months ended June 30, 2010:

Restricted Stock Awards	Number of Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2010	42,000	$ 2.19		
Awarded	21,000	2.53		
Released	(21,000)	1.95		
Forfeited				
Outstanding at June 30, 2010	42,000	$ 2.48	0.53	$ 91,560

The following table summarizes restricted stock unit activity under the Plan for the six months ended June 30, 2010:

Restricted Stock Units	Number of Shares	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2010	107,454		
Awarded			
Released	(17,653)		
Forfeited	(11,120)		
Outstanding at June 30, 2010	78,681	1.32	$ 172,000
Vested and expected to vest at June 30, 2010	64,157	1.19	$ 140,000

5. Other Comprehensive Income (Loss)

Other comprehensive income (loss) refers to revenue, expenses, gains and losses that, under GAAP, are recorded as an element of shareholders equity and excluded from net income (loss). The Company s accumulated other comprehensive loss as of June 30, 2010, and December 31, 2009, is comprised of foreign currency translation adjustments resulting from its subsidiaries not using the U.S. dollar as their functional currency, and unrealized gains and losses, net of tax as applicable, on the Company s investments.

The components of other comprehensive income (loss) were as follows (in thousands):

	Three Months ended June 30,		Six Months ended June 30,	
	2010	**2009**	**2010**	**2009**
Net unrealized gain (loss) on investments	$	$ (121)	$ 308	$ (188)
Foreign currency translation loss	(20)	(32)	(19)	(28)
Other comprehensive income (loss)	$ (20)	$ (153)	$ 289	$ (216)

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6. Commitments and Contingencies

Contractual Commitments

The Company s principal commitments consist of obligations outstanding under operating leases, which expire through 2014. The Company has lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Chanhassen, Minnesota; Dallas, Texas; Taipei, Taiwan; Beijing, China and Tokyo, Japan. The Company leases office space in Akron, Ohio on a month-to-month basis.

Under the terms of the Company s corporate headquarters lease signed in February 2004, the landlord has the ability to demand payment for cash payments forgiven in 2004 if the Company defaults under the lease. The amount of the forgiven payments for which the landlord could demand repayment was $998,000 at June 30, 2010, and decreases on a straight-line basis to zero over the term of the lease, which expires in 2014.

Rent expense was $395,000 and $789,000 for the three and six months ended June 30, 2010, respectively. Rent expense was $404,000 and $782,000 for the three and six months ended June 30, 2009, respectively. As of June 30, 2010, the Company had $875,000 pledged as collateral for a bank letter of credit under the terms of its headquarters facility lease. The pledged cash supporting the outstanding letter of credit is recorded as restricted cash.

Contractual commitments at June 30, 2010 were as follows (in thousands):

Operating leases:	
Remainder of 2010	$ 621
2011	1,064
2012	1,079
2013	1,089
2014	770
Total commitments	$ 4,623

Legal Proceedings

IPO Litigation

In Summer and early Fall 2001, four shareholder class action lawsuits were filed in the United States District Court for the Southern District of New York against the Company, certain of the Company s current and former officers and directors (the Individual Defendants), and the underwriters of the Company s initial public offering (the Underwriter Defendants). The complaints were consolidated into a single action and a Consolidated Amended Complaint, which was filed on April 19, 2002. The operative complaint alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The suit purported to be a class action filed on behalf of purchasers of the Company s common stock during the period from October 19, 1999 to December 6, 2000. The plaintiffs alleged that the Underwriter Defendants agreed to allocate stock in the Company s initial public offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. The plaintiffs alleged that the prospectus for the Company s initial public offering was false and misleading in violation of the securities laws because the Company did not disclose these arrangements. The action sought damages in an unspecified amount. On December 5, 2006, the Second Circuit Court of Appeals vacated a decision by the district court granting class certification in six of the coordinated cases, which are intended to serve as test, or focus cases. The plaintiffs selected these six cases, which do not include the Company. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by the plaintiffs, but noted that the plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

The parties in the approximately 300 coordinated cases, including the parties in the Company s case, reached a settlement in early 2009. As part of the settlement, the insurers for the issuer defendants will make the entire settlement payment on behalf of the issuers, including the Company. On October 5, 2009, the district court granted final approval of the settlement. Three objectors filed a petition to the Second Circuit seeking permission to appeal the district court s final approval order on the basis that the settlement class is broader than the class previously rejected by the Second Circuit in its December 5, 2006 order vacating the district court s order certifying classes in the focus cases. Six notices of appeal have also been filed, including one notice filed by the group of objectors that filed the petition to appeal. Following the district court s final approval of the settlement, the Company determined that it is unlikely that the Company will be liable for any damages that will not be paid for by the Company s insurance carriers, even if any appeals are successful. As a result, it was determined that an accrued legal fees liability of

$534,000 was no longer probable. Consequently, this liability was reversed, which resulted in a reduction of selling, general and administrative expense during the third quarter of 2009. However, due to the inherent uncertainties of litigation, subsequent events could affect the assessment of this liability and this disclosure.

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7. Segment Information

The Company has one operating segment software and services delivered to smart device makers. The following table summarizes information about the Company s revenue and long-lived asset information by geographic areas (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Total revenue:				
North America	$ 22,922	$ 15,707	$ 38,356	$ 31,747
Asia	3,505	333	4,635	796
Other foreign	478	74	859	248
Total revenue (1)	$ 26,905	$ 16,114	$ 43,850	$ 32,791

	June 30, 2010	December 31, 2009
Long-lived assets:		
North America	$ 1,856	$ 2,231
Asia	76	103
Total long-lived assets	$ 1,932	$ 2,334

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

8. Significant Risk Concentrations

Significant Customer

Ford Motor Company (Ford) accounted for $6.2 million, or 23%, of total revenue for the three months ended June 30, 2010, and $8.5 million, or 19%, of total revenue for the six months ended June 30, 2010. No other customer accounted for 10% or more of total revenue for the three or six months ended June 30, 2010. Ford accounted for $5.2 million, or 32%, of total revenue for the three months ended June 30, 2009, and $10.4 million, or 32%, of total revenue for the six months ended June 30, 2009. No other customer accounted for 10% or more of total revenue for the three or six months ended June 30, 2009.

Ford had an accounts receivable balance of $7.5 million, or 45% of total accounts receivable, as of June 30, 2010. Of this amount, $333,000 was past due as of June 30, 2010 and was collected subsequent to June 30, 2010. No other customer accounted for 10% or more of total accounts receivable as of June 30, 2010. Ford had an accounts receivable balance of $7.7 million, or 53% of total accounts receivable, as of June 30, 2009, all of which was subsequently collected, and no other customer accounted for 10% or more of total accounts receivable as of June 30, 2009.

Significant Supplier

The Company has an OEM Distribution Agreement with Microsoft, which enables the Company to sell Microsoft Windows Embedded operating systems to its customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico. Software sales under this agreement constitute a significant portion of the Company s revenue. The agreement is typically renewed annually or semi-annually, and there is no automatic renewal provision in the agreement. This agreement will expire on June 30, 2011.

The Company signed an additional distribution agreement with Microsoft in November 2009, under which the Company is licensed to sell Microsoft Windows Mobile operating systems and related applications such as Microsoft s Office Mobile on a world-wide basis. This agreement will expire in November 2011.

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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 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, anticipate, believe, estimate, predict, potential, continue, or the negative of these terms or other comparable terminology, which when use 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, 2009 entitled Risk Factors, as well as those contained from time to time in our other filings with the SEC. 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 and engineering services to companies that develop smart devices and to companies that assist others in developing smart devices. A smart device is a dedicated purpose computing device that typically has a display, runs an operating system (e.g., Microsoft® Windows® CE) and may be connected to a network via a wired or wireless connection. Examples of smart devices 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 devices targeted at automotive applications. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile. However, as a result of several acquisitions, coupled with our strategic intent to broaden our market focus, we provide software and engineering services to customers developing devices utilizing other operating systems such as Android, Linux and Symbian.

We have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class original equipment manufacturers (OEM s), original design manufacturers (ODM s), and enterprises as well as silicon vendors and peripheral vendors which purchase our software and engineering services for purposes of facilitating processor and peripheral sales to the aforementioned customer categories. In the case of enterprises, our customers include those which 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 the testing thereof. The software and engineering services 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

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenue and expenses and disclosure of contingent assets and liabilities. Estimates are used for, but not limited to, determining the selling price of deliverables in multiple element revenue arrangements, assessing the adequacy of the allowance for doubtful accounts, and estimating the percentage-of-completion on fixed price service contracts, valuation of investments and the realization of deferred tax assets among other things. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. The SEC has defined a company s critical accounting policies as those that are most important to the portrayal of our financial condition and results of operations, and those that require us to make our most difficult and subjective judgments, often as a result of the need to make estimates related to matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are relevant to understanding our results. For additional information see Item 8 of Part II, Financial Statements and Supplementary Data Note 1 Description of

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Business and Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2009. Although we believe that our estimates, assumptions and judgments are reasonable, they are necessarily based upon presently available information. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

Revenue Recognition

We recognize revenue from software and engineering service sales when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the selling price is fixed or determinable; and collectability is reasonably assured. Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and time records are generally used to verify delivery. We assess whether the selling price is fixed or determinable based on the contract and/or customer purchase order and payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. Periodically, we will begin work on engineering service engagements prior to having a signed contract and, in some cases, the contract is signed in a quarter after which service delivery costs are incurred. We do not defer costs associated with these uncontracted engagements even though the underlying contract might be signed prior to the reporting of our results.

We recognize software revenue upon shipment provided that no significant obligations remain on our part, substantive acceptance conditions, if any, have been met and the other revenue recognition criteria have been met. Service revenue from time and materials contracts and training services is recognized as services are performed. Certain fixed-price and time and materials with cap engineering service contracts that require significant production, modification, or customization of software, are accounted for using the percentage-of-completion method. We use the percentage-of-completion method of accounting because it is the most accurate method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; it is a better measure of periodic income results than other methods and it better matches revenue recognized with the costs incurred. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. Significant judgment is required when estimating total hours and progress to completion on these arrangements which determines the amount of revenue we recognize as well as whether a loss is recognized if one is expected to be incurred for the remainder of the project. Revisions to hour and cost estimates are incorporated in the period in which the amounts are recognized if the results of the period have not been reported; otherwise, the revision of estimates are recognized in the period in which the facts that give rise to the revision become known.

We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support or maintenance (PCS). As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements. PCS includes rights to upgrades, when and if available, telephone support, updates, and enhancements. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. If VSOE has not been established, and there is no third party evidence of selling price, we estimate the proportion of the selling price attributed to each delivered element. Accordingly, the judgments involved in assessing the fair values of various elements of an agreement can impact the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition, but would not change the total revenue recognized on the contract.

When elements such as software and engineering services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, our best estimate of the selling price provided that such element meets the criteria for treatment as a separate unit of accounting.

When engineering services and royalties are contained in a single arrangement, we recognize revenue from engineering services as earned in accordance with the criteria above even though the effective rate per hour may be lower than typical because the customer is contractually obligated to pay royalties on their device shipments. We recognize royalty revenue, classified as software revenue, when the royalty report from the customer is received or when such royalties are contractually guaranteed and the revenue recognition criteria are met, particularly that collectability is reasonably assured.

Allowance for Doubtful Accounts

Our accounts receivable balances are net of an estimated allowance for doubtful accounts. We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We estimate the collectability of our accounts receivable and record an allowance for doubtful accounts. When evaluating the adequacy of the allowance for doubtful accounts, we consider many factors, including analysis of accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimate.

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Investments

Investments are reviewed quarterly for indicators of impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If an investment is determined to be impaired, we determine whether the impairment is temporary or other-than-temporary by evaluating, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. If a decline in fair value is determined to be temporary, a valuation allowance is recorded against the investment, and offset to other comprehensive income. If a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other expense and a new cost basis in the investment is established.

Stock-Based Compensation

We record compensation expense associated with stock options and other forms of equity compensation using the straight-line method over the life of each vesting traunch of the awards. Compensation expense includes the impact of an estimate for forfeitures for all awards, and the effect of actual forfeitures are recorded to the extent that they differ materially from our estimates.

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Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the countries and other jurisdictions in which we operate. This process involves estimating our current tax exposure together with assessing temporary differences resulting from the differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance, or increase this allowance in a period, it may result in an expense within the tax provision. Conversely, to the extent we determine that a valuation allowance is no longer necessary, it may result in a benefit within the tax provision. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have provided a full valuation allowance on deferred tax assets because of our uncertainty regarding their realizability. If we determine that it is more likely than not that the deferred tax assets, or a portion thereof, would be realized, the valuation allowance would be reversed. In order to realize our deferred tax assets, we must be able to generate sufficient future taxable income. Because we generated a net loss for the last fiscal year, and the current economic climate calls into question our ability to generate net income with certainty in the near future, we continued to maintain a full valuation allowance on our deferred tax assets as of June 30, 2010.

Because we do business in foreign tax jurisdictions, our sales may be subject to other taxes, particularly withholding taxes. The tax regulations governing withholding taxes are complex, causing us to have to make assumptions about the appropriate tax treatment and estimates of the resulting withholding taxes. Further, we make sales in many jurisdictions across the United States, where tax regulations are increasingly becoming more aggressive and complex. We must make assumptions about whether nexus has been established, and if so what the appropriate tax treatments are, and make estimates for sales, franchise, income and other state taxes.

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 June 30,		**Six Months Ended June 30,**	
	2010	**2009**	**2010**	**2009**
	(unaudited)		**(unaudited)**	
Revenue:				
Software	64%	49%	67%	49%
Service	36	51	33	51
Total revenue	100	100	100	100
Cost of revenue:				
Software	52	36	54	37
Service	19	37	26	36
Total cost of revenue	71	73	80	73
Gross profit	29	27	20	27
Operating expenses:				
Selling, general and administrative	11	19	14	19
Research and development	3	6	4	7
Total operating expenses	14	25	18	26
Income from operations	15	2	2	1
Other income (expense)	0	0	(1)	0
Income before income taxes	15	2	1	1

Income tax benefit (expense)	0	0	0	0
Net income	15%	2%	1%	1%

Revenue

Our revenue is generated by the sale of software, both our own proprietary software and software from third-parties, and the sale of engineering services. Total revenue increased $10.8 million, or 67%, to $26.9 million during the three months ended June 30, 2010, from $16.1 million in the year ago period. This increase was driven by higher sales of third-party software and higher service revenue, offset in part by a decline in proprietary software revenue.

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Total revenue increased $11.1 million, or 34%, to $43.9 million for the six months ended June 30, 2010, from $32.8 million in the year ago period. This increase was driven by higher sales of third-party software and higher service revenue, offset in part by a decline in proprietary software revenue.

Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and services delivered to foreign customers from our operations located in North America. Our international operations outside of North America consisted principally of operations in Taiwan. We also have established minor sales and/or support presences in Japan, China, India, and the United Kingdom. Revenue from customers located outside of North America was $4.0 million during the three months ended June 30, 2010, or 15% of total revenue, an increase from $407,000, or 3% of total revenue, in the year ago period. This international growth was primarily attributable to sales of the Microsoft Windows Mobile operating system in the Asia Pacific (APAC) region, following the signing of a new Distribution Agreement (the Winmo ODA) in November 2009, under which we are licensed to sell Microsoft Windows Mobile operating systems on a worldwide basis.

Software revenue

Software revenue consists of sales of third-party software and sales of our own proprietary software products, which include software licenses, royalties from our software products, sales of our software development kits, and support and maintenance revenue, as well as royalties from certain engineering service contracts. Software revenue for the three and six months ended June 30, 2010 and 2009 was as follows (dollars in thousands):

	Three months ended June 30, 2010 (unaudited)	Three months ended June 30, 2009 (unaudited)	Six months ended June 30, 2010 (unaudited)	Six months ended June 30, 2009 (unaudited)
Software revenue:				
Third-party software	$ 16,294	$ 6,641	$ 27,328	$ 13,978
Proprietary software	952	1,184	1,930	2,145
Total software revenue	$ 17,246	$ 7,825	$ 29,258	$ 16,123
Software revenue as a percentage of total revenue	64%	49%	67%	49%
Third-party software revenue as a percentage of total software revenue	94%	85%	93%	87%

The majority of our third-party software revenue is comprised of sales of Microsoft Embedded operating systems in North America. As we are now selling Microsoft Windows Mobile operating systems on a world-wide basis, an increasing percentage of our third-party software sales are generated from customers located outside of North America. Third-party software revenue increased $9.7 million, or 145%, for the three months ended June 30, 2010, as compared to the year ago period. We believe that improving economic conditions in the United States led to a $6.5 million increase in Microsoft Embedded operating system sales during the three months ended June 30, 2010, as compared to the year ago period. Microsoft Windows Mobile operating system sales were $2.5 million during the three months ended June 30, 2010, compared to zero in the year ago period, as we began selling under our Winmo ODA in November 2009.

Third-party software revenue increased $13.4 million, or 96%, for the six months ended June 30, 2010, as compared to the year ago period with the increase driven by the same factors that accounted for the three-month increase. Total Microsoft Windows Mobile operating system sales for the six months ended June 30, 2010 were $3.7 million compared to zero in the year ago period.

Proprietary software revenue decreased $232,000, or 20%, for the three months ended June 30, 2010, as compared to the year ago period. This decrease was driven by a $323,000 decline in TestQuest software license revenue due to a large license sale which benefited the year ago period. This decrease was offset in part by a $165,000 increase in our TestQuest support and maintenance revenue. Proprietary software revenue decreased $215,000, or 10%, for the six months ended June 30, 2010, as compared to the year ago period. This decrease was primarily driven by lower SmartBuild reference design royalties and lower service contract royalties.

We currently expect that full year third-party software revenue will increase in 2010, as compared to 2009 because of the continued stabilization of, and growth in, demand for Microsoft Embedded operating system sales coming off the improvement we experienced in the second half of

2009 and the first two quarters of 2010. Further, 2010 will benefit from sales of Microsoft Windows Mobile operating systems compared to none in 2009. We also currently believe our full year proprietary software revenue will increase in 2010 as compared to 2009 primarily because we expect TestQuest-related product revenue to show improvement in the second half of the year.

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Service revenue

Service revenue for the three and six months ended June 30, 2010 and 2009 was as follows (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Service revenue	$ 9,659	$ 8,289	$ 14,592	$ 16,668
Service revenue as a percentage of total revenue	36%	51%	33%	51%

Service revenue increased $1.4 million, or 17%, during the three months ended June 30, 2010, as compared to the year ago period. This increase was primarily driven by a $1.0 million increase in service revenue related to our project with Ford Motor Company (Ford), and to a lesser extent a $329,000 increase in service revenue in the APAC region and Europe. Ford continues to be our largest engineering services customer, representing 64% of service revenue during the three months ended June 30, 2010, compared to 62% of service revenue in the year ago period. The second quarter of 2010 was positively affected by an amendment signed with Ford under which Ford agreed to pay us $3.2 million for overruns we incurred on the existing project with them, which we subsequently concluded in July 2010. This project was accounted for under the percentage of completion method of revenue recognition beginning in the second quarter of 2009. The amendment also included $577,000 of changes of scope on the existing project. Of the $3.2 million associated with project overruns, $3.1 million was recognized as service revenue during the three months ended June 30, 2010. Of the $3.1 million, $2.5 million would have been recognized during the three months ended March 31, 2010, under percentage-of-completion accounting, had the amendment been executed prior to us filing our first quarter financial statements. As such, this quarter s results including revenue, gross profit, gross margin and net income were positively affected by that $2.5 million attributable to the first quarter of 2010 as a result of the amendment. However, the six months ended June 30, 2010 would not have been affected in total had the amendment been executed prior to filing the first quarter financial statements.

Also in June 2010, we signed a new statement of work with Ford which defines a new working relationship between us and Ford going forward. Under this new arrangement, Ford has committed to pay a minimum of $5.6 million for a defined number of our engineering resources over a one year period. Revenue for these services will be recognized ratably as the services are rendered over the life of the agreement. We recognized $286,000 under this new statement of work during the three months ended June 30, 2010. Total revenue related to Ford was $6.2 million during the three months ended June 30, 2010, compared to $5.2 million in the year ago period.

Overall, North American service revenue not related to Ford was relatively flat compared to the year ago period, at $3.0 million, but did increase by 33% as compared to the three months ended March 31, 2010.

Service revenue decreased $2.1 million, or 12%, for the six months ended June 30, 2010 as compared to the year ago period. This decrease was primarily due to a $2.7 million decline in North America service revenue, offset in part by a $352,000 increase in the APAC region, and a $277,000 increase in Europe. The decline in North American service revenue was primarily attributable to Ford revenue which declined $1.9 million to $8.5 million during the six months ended June 30, 2010, from $10.4 million in the year ago period.

Overall, North American service revenue not related to Ford declined $627,000, or 11%, as compared to the year ago period.

We currently expect service revenue to decline significantly in the third quarter of 2010 as compared to the second quarter due to a significant decrease in service revenue attributable to Ford. We currently expect service revenue attributable to Ford to decline from $6.2 million in the second quarter to $2.3 million in the third quarter.

Gross profit and gross margin

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software as well as the amortization of certain intangible assets related to acquisitions.

Cost of revenue related to service revenue consists primarily of salaries and benefits, contractor costs and re-billable expenses, plus related facilities and depreciation costs. Gross profit on the sale of third-party software products is also positively affected by rebate credits we receive from Microsoft which we earn through the achievement of defined objectives.

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