

BSQUARE CORP /WA
Form 10-K
February 19, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 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)

Washington 91-1650880
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

110 110th Avenue NE, Suite 300, Bellevue, Washington 98004

(Address of principal executive offices, including zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|----------------------------|--|
| Common Stock, no par value | The NASDAQ Stock Market LLC (NASDAQ Global Market) |

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Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act. Yes No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of common stock held by non-affiliates of the registrant as of June 30, 2014 was approximately \$35,049,000 based on the closing price of \$3.20 per share of the registrant's common stock as listed on the NASDAQ Global Select Market.

The number of shares of common stock outstanding as of January 31, 2015: 11,769,452

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be delivered to shareholders in connection with the 2015 annual meeting of shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

BSQUARE CORPORATION

FORM 10-K

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PART I

Item 1. Business.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains "forward-looking statements" within the meaning of the safe-harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements can often be identified by words such as: "expect," "believe," "estimate," "plan," "strategy," "future," "potential," "continue," "may," "should," "will," and similar references to future periods. Examples include, among others, statements about: expected operating results, such as revenue growth and earnings; anticipated levels of capital expenditures; future market conditions; our belief that we have sufficient liquidity to fund our business operations for at least the next 12 months; expectations of the effect on our financial condition of claims, litigation, contingent liabilities and supplier audits; and strategies for customer retention, growth, product and service development, and market position.

Forward-looking statements are neither historical facts nor assurances about future performance. Instead they are only predictions, based on current beliefs, expectations and assumptions about the future of our business and other future conditions. Forward-looking statements are subject to known and unknown risks, uncertainties and changes in circumstances that are difficult to predict and many of which are outside of our control. Actual events and results may differ materially. Therefore, you should not rely on any of these forward-looking statements.

Any forward-looking statement made by us in this report is based only on information available to us on the date of this report. Except as may be required by law, we undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future developments or otherwise.

Our forward-looking statements can be affected by inaccurate assumptions we might make or by known or unknown risks, uncertainties and other factors. We discuss many of these risks, uncertainties and other factors in this Annual Report on Form 10-K in greater detail under the Item 1A—"Risk Factors." We caution readers that our business and financial performance are subject to substantial risks and uncertainties.

BUSINESS

Overview

As used in this Annual Report on Form 10-K, "we," "us," "our," "the Company" and "Bsquare" refer to BSQUARE Corporation. We primarily resell software from Microsoft Corporation ("Microsoft") and provide software solutions and related engineering services 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™ platform) and is usually connected to a network or data cloud via a wired or wireless connection. 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, smart vending machines and in-vehicle telematics and entertainment devices. We focus on smart, connected systems that utilize various Microsoft Windows Embedded and Windows Mobile operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX.

We have been providing software solutions for smart, connected systems since our inception. Our customers include world class original equipment manufacturers ("OEMs"), original design manufacturers ("ODMs") and corporate enterprises ("Enterprises"), as well as silicon vendors ("SVs") and peripheral vendors which purchase our software solutions for purposes of facilitating processor and peripheral sales. In the case of Enterprises, our customers include those that develop, market and distribute smart, connected systems on their own behalf as well as those that purchase systems from OEMs or ODMs and require additional software, integration and/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.

Increasingly, we intend to focus on developing and offering our own products such as DataV™ to address the emerging Internet of Things (“IoT”) market, which is the interconnection of uniquely identifiable embedded computing devices within the existing internet infrastructure. Similarly, we intend to focus on increasing the amount of our own products and know-how, including in our MobileV™ product, a complete hardware and software reference solution for OEMs building durable and rugged handhelds and industrial tablets.

We were incorporated in the State of Washington in July 1994. Our principal office is located at 110 110th Avenue NE, Suite 300, Bellevue, Washington 98004, and our telephone number is (425) 519-5900.

Industry Background

The increasing opportunity for connectivity and exchange of data coupled with the rise of cloud storage and cloud computing infrastructure is driving new applications for smart, connected systems of all kinds.

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The smart, connected systems industry is characterized by a wide variety of software and hardware configurations and end-user applications, often designed to address a specific vertical market. To accommodate these diverse characteristics in a cost-effective manner, OEMs, ODMs and Enterprises require operating systems and software that can support a diverse set of hardware requirements and connect to a wide variety of networks, systems, peripherals, content and applications.

The smart, connected systems marketplace is being influenced by the following factors:

- Continuing demand by business professionals and consumers for integrated mobile devices, which combine telephony, data (such as email and internet browsing), multimedia, location awareness and cameras;
- Businesses are increasingly deploying specialized devices in stores, shopping centers, shop floors, etc., or to their employees who work in the field but need connectivity to business systems and data;
- The ubiquity of cellular and wireless local area networks (“WLANs”) is driving rapid adoption of smart connected systems that leverage broadband and high-speed wireless data networks, including Internet Protocol (“IP”) set-top boxes, voice-over-IP (“VoIP”) phones, residential gateways, and home networking solutions linking smart connected systems with personal computers;
- The vastly increasing number of sensors and similar devices requires new solutions for these devices to interact with other devices autonomously through the “Internet of Things” and to provide data to applications, both those that reside local to the device and those running in the cloud;
- Expectations for device functionality continue to grow. Users expect to be able to access email and the internet, synchronize their devices with cloud and corporate data sources and deploy multiple applications on their devices;
- The availability of multimedia content has increased demand for high-performance, multimedia-capable devices that are able to access, share and play audio, video and application content located on remote computers;
- Security is an increasingly important concern as devices are now often able to access networks and store sensitive information locally such as email, spreadsheets and other documents. Users are demanding that these types of information be protected in the same ways they are protected on the desktop;
- Higher bandwidth networks coupled with larger displays and increased processing power found on new devices means that more multimedia content will be available to devices—increasing demand for digital rights management, content management and related technologies; and
- Increase in device complexity is being driven by rising user expectations of functionality, complex device interactions with wireless networks and updated versions of embedded operating systems and silicon processors, all of which are driving OEMs, ODMs and Enterprises to continually refresh and update their device designs.

Software Solutions and Related Engineering Services for Smart Connected Systems

Our customers include world class OEMs and ODMs, Enterprises, SVs and peripheral vendors which are developing smart connected systems or assisting others in doing so. Representative customer engagements in 2014 included the following:

- We continued support of the second generation of MyFord Touch, a product of Ford Motor Company (“Ford”). The MyFord Touch infotainment system is an in-car communications and entertainment system which enables drivers of Ford’s car offerings to access a wide range of connected information and entertainment experiences including music and multi-media services, hands-free telephony, internet-enabled applications, language services, news and navigation;
- We have been a supplier to Outerwall (formerly Coinstar) since 2005 for their Windows Embedded Operating Systems that are deployed on their Coin Kiosks. During the last several years we have provided Outerwall with engineering services for their New Venture Kiosks in addition to the Coin Kiosk. In 2013 and 2014, we provided licensing consultation and engineering services for the Redbox division of Outerwall.
- The Coca-Cola Company (“Coca-Cola”) continues to engage us in the development and support of Freesty[®] its next generation drink dispensing machine.
- We initiated work with Google to assist in the development of their advanced technology “Project Tango.” We have expanded our work with Google to include additional projects.

The software we deliver to our customers as part of our smart connected software solutions takes three forms. The first is our own proprietary software products, the second is best-of-class third-party software products and the last is custom software delivered through our engineering services teams. The majority of the software we sell is from Microsoft. Due to the complexity of embedded software, the integration of our own proprietary software, third-party software products and customer software on customers' devices often requires us to provide additional engineering services addressing systems integration, customization and/or optimization as well as quality assurance testing. Our goal is to increase the breadth and depth of our software product and engineering service offerings to our customers to enhance our position as an overall smart connected software solutions provider.

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Software revenue for the last two fiscal years was as follows (in thousands):

| | Year Ended December 31, | | | |
|---|----------------------------|----------|----|---|
| | 2014 | 2013 | | |
| Software revenue: | | | | |
| Third-party software | \$73,933 | \$70,891 | | |
| Proprietary software | 2,314 | 2,513 | | |
| Total software revenue | \$76,247 | \$73,404 | | |
| Software revenue as a percentage of total revenue | 79 | % | 80 | % |
| Third-party software revenue as a percentage of total software revenue | 97 | % | 97 | % |

Third-Party Software Products

We have distribution agreements with multiple third-party software vendors. Our ability to resell these third-party software products, whether stand-alone or in conjunction with our own proprietary software and engineering service offerings, provides our customers with a significant solution source for their project needs. Our primary third-party software offerings include the following:

- For 16 years, we have been a Microsoft Corporation authorized Value-Added Provider (“VAP”) of Windows Embedded operating systems and toolkits for the complete line of Windows Embedded Products, including major product families such as Windows Embedded Compact, Windows Embedded Standard and Windows Embedded Server. We are authorized to sell Windows Embedded operating systems in the United States, Canada, Mexico, Argentina, Brazil, Chile, Columbia, Peru, Puerto Rico, the Caribbean (excluding Cuba), the European Union, the European Free Trade Association, Turkey and Africa. Of our total revenue in 2014, 64% was generated through the sale of Windows Embedded operating systems, compared to 58% in 2013. Our current distribution agreements related to Windows Embedded expire in June 2016;
- We have been a Microsoft authorized VAP of Windows Mobile operating systems since November 2009. Along with Windows Mobile operating systems, we also sell Microsoft’s Office Mobile product. We are currently authorized to sell Windows Mobile operating systems and related products in North America, South America, and Central America (excluding Cuba) (the “Americas”), Japan, Taiwan, and the region comprised of Europe, the Middle East, and Africa (“EMEA”). Of our total revenue in 2014, 9% was generated through the sale of Windows Mobile operating systems, compared to 11% in 2013. Our current distribution agreements related to Windows Mobile expire in June 2015,
- We are an authorized distributor for Adobe Flash technologies and Adobe Reader. We have the right to distribute Adobe Flash Lite licenses on a worldwide basis;
- We are an authorized distributor of Intel Corporation’s Embedded Security product in North America; and
- We sub-license and resell mobile handset design files from Aava Mobile Oy as a part of our MobileV product.

The sale of Microsoft operating systems has accounted for substantially all of our third-party software revenue historically, including 95% of third-party software revenue in 2014 and 90% of third-party software revenue in 2013.

Engineering Service Offerings

We offer a variety of engineering services to our customers including:

- Architectural and system design;
- Software design and development;
- Platform development systems integration;
- Application, middleware and multimedia software development;
- Quality assurance and testing;
- Device solution strategy consulting;
- Technical support;
- Implementation; and
- Test Automation Engineering and Consulting Services.

Customers engage us for engineering services due to our extensive device software development and testing experience and because of our deep experience with embedded and mobile operating systems. We believe that engaging us on a new device design

typically results in shorter development cycles and reduced time-to-market, lower overall costs to complete projects, and enhanced product robustness and features, which a customer may otherwise have been unable to achieve.

Service revenue for the last two fiscal years was as follows (in thousands):

| | Year Ended | | | |
|--|--------------|---|----------|---|
| | December 31, | | | |
| | 2014 | | 2013 | |
| Service revenue | \$19,669 | | \$18,704 | |
| Service revenue as a percentage of total revenue | 21 | % | 20 | % |

Service revenue related to Coca-Cola was \$4.6 million, or 24% of 2014 service revenue and \$3.2 million, or 17% of service revenue in 2013. Service revenue related to the MyFord Touch program was \$2.8 million, or 14% of service revenue, in 2014 and \$4.5 million, or 24% of service revenue, in 2013.

Proprietary Software Products

Our primary proprietary software offerings being actively sold or developed include:

- HTML5 Rendering Engine—Our award-winning HTML5 Rendering Engine is based on the open-source WebKit platform which is maintained by a number of leading internet and device companies. Using WebKit, device makers can create portable applications and user interfaces for their devices using the industry-standard HTML5 markup language. We ported WebKit to the latest versions of Microsoft’s Windows Embedded Compact Operating System and sell our porting layer to customers along with engineering services to implement our WebKit port on their devices;
- TestQuest™ 10—TestQuest 10 is our latest generation software testing automation tool that provides customers with a complete test solution that brings together everything necessary to test smart connected systems including tools to create and manage test cases, a platform that allows teams to collaborate on test development, an execution environment that enables tests to be executed on the smart connected systems and capture results, and a reporting tool that allows customers to analyze test results;
- DataV™—An actionable data solution for the IoT market. DataV includes software products, applications and services that turn raw device data into useful, meaningful and actionable data. The goal of DataV is to help our customers unlock their data and use the data to lower costs, improve and enhance operations, lower go-to-market risks, and identify new revenue opportunities; and
- MobileV™—A complete hardware and software reference solution based on Intel® architecture, Microsoft Windows® Embedded 8.1 and Google Android 4.4 operating systems. MobileV provides a common platform for OEMs building multiple device form factors to include durable and rugged class handhelds and industrial tablets. MobileV combines Windows Embedded 8.1 and Android 4.4 with cutting-edge Intel-based board designs from Aava Mobile, along with Bsquare’s MobileV UX software, and significantly reduces engineering effort and time to market for next generation devices.

Strategy

Our strategy is to continue to enhance our position as a provider of software solutions and related engineering services for smart connected systems, ultimately becoming the go-to solutions provider for our customers and potential customers around the globe. To advance this strategy, we intend to focus on the following:

- Expanding the breadth of services we offer to our customers, particularly those that are focused on making existing smart connected systems more useful and valuable to their customers;

- Focusing on our core geographic areas of North America, the United Kingdom, Taiwan and Japan;
- Building our offerings and capabilities in the rapidly growing Internet of Things market. As we drive to grow in this market, we will seek to deepen our customer relationships in our software solutions and engineering services businesses to deliver a family of products and services that will turn raw device data into useful, meaningful and actionable information; and
- Seeking additional software products, such as DataV and MobileV, in which to invest.

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Relationship with Microsoft and Impact on our Smart Connected Solutions Business

We have a long-standing relationship with Microsoft and this relationship is critical to the continuing success of our business. Our credentials as a Microsoft partner include:

- We have been one of Microsoft's largest distributors of Windows Embedded operating systems for over 16 years;
- We have been a distributor of Microsoft's Windows Mobile operating systems since November 2009;
- We are a Windows Embedded Gold-level Systems Integrator;
- We were the OED Americas Channel Sales & Marketing Award recipient for Distributor Sales Excellence in 2013;
- We were the Microsoft Embedded Distributor of the Year for 2011;
- We received a Microsoft Technical Excellence Award for our delivery of highest quality technical solutions on the latest Windows Embedded technologies in the European region in 2011;
- Our HTML5 Rendering Engine won a Microsoft Technical Excellence Award in 2012;
- We are a developer and provider of Microsoft Official Curriculum Training for Windows Embedded Compact and Windows Embedded Standard;
- We are a Preferred Provider of Visual Tools for Microsoft;
- We are a Gold-level member of Microsoft's Third-Party Tools Provider Program;
- We are a Silver Intelligent Systems partner;
- We are a Silver Data Analytics partner;
- We are a Silver Data Platform partner; and
- We have been engaged by Microsoft on various engineering service engagements.

We work closely with Microsoft executives, developers, product managers and sales personnel. We leverage these relationships in a variety of ways, including:

- We gain early access to new Microsoft embedded software and other technologies;
- We are able to leverage co-marketing resources, content and strategies from Microsoft, including market development funds, to support our own marketing and sales efforts;
- We participate in Microsoft-sponsored trade shows, seminars, and other events;
- We receive sales leads from Microsoft; and
- We receive rebates from Microsoft based upon the achievement of predefined sales objectives.

See Item 1A, "Risk Factors," for more information regarding our relationship with Microsoft.

Customers

Customers purchasing third-party software and our software solutions and engineering services include leading OEMs, ODMs, Enterprises, SVs and peripheral vendors seeking to leverage the software we provide them, be it our own proprietary software, third-party software or custom software developed via our engineering services, to develop high-quality, smart connected systems that meet the requirements of numerous end-markets. Representative customers include Coca-Cola, Future Electronics, Elo Touch Solutions, Honeywell International, Inc., IGT, Microsoft, Mitsubishi Electric Corporation, Panasonic, Elektrobit, Bally and several industrial handset companies.

Sales and Marketing

We market our software solutions and engineering services utilizing a direct sales model. We have sales personnel throughout the United States and in Taiwan, the United Kingdom and Japan. Historically, we have not made significant use of resellers, channel partners, representative agents or other indirect channels.

Key elements of our sales and marketing strategy include direct marketing, content marketing, trade shows, event marketing, public relations, analyst relations, social media properties, customer and strategic alliance partner co-marketing programs and a comprehensive website. We rely significantly on lead referral and other marketing support programs from strategic partners.

Research and Development

Our research and development personnel are responsible for the design, development and release of our proprietary software products. Members of our research and development staff work closely with our sales and marketing departments, as well as with our customers and potential customers, to better understand market needs and requirements. We perform our research and development primarily utilizing engineering staff located in the United States. Research and development expense was \$1.7 million and \$2.8 million in 2014 and 2013, respectively. The decrease was driven largely by our cost reduction efforts in the fourth quarter of 2013.

Competition

The market for smart connected systems software and services is extremely competitive. We face competition from the following:

- Microsoft Windows Embedded and Windows Mobile operating system distributors such as Arrow Electronics, Inc., Avnet, Inc. and Synnex Corporation in Taiwan;
- Our current and potential customers' internal research and development departments, which may seek to develop their own software solutions which compete with our proprietary software products and engineering services;
- Engineering service firms, including off-shore development companies, such as Adeneo, SymphonyTeleca division of Harmon Industries and Wipro;
- ODMs, particularly those in Taiwan and China, which have added or are adding software development capabilities to their offerings;
- Contract manufacturers which have added or are adding software development capabilities to their offerings;
- Mobile and embedded test automation providers including Perfecto Mobile, mVerify, JAMO Solutions, SmartBear Software (AutomatedQA), TestPlant (eggPlant) and Keynote. In this market we also compete against customers' internally created tools and against manual testing;
- Marketing agencies and specialized vendors who provide mobile application services; and
- We will encounter increasing competition in the growing Internet of Things market from a number of additional software and service providers as we expand our focus on this market in 2015 and beyond.

Some of our competitors focus on only one aspect of our business or offer complementary products which can be integrated with our products. As we develop and bring to market new software products and service offerings, we may begin competing with companies with which we have not previously competed. Further, as we expand the geographic markets into which we sell our software solutions and related services, or increase our penetration therein, we may expect to increasingly compete with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share.

Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced software and service revenue opportunities for us. The barrier to entering the market as a provider of Microsoft-based smart connected systems software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded and Windows Mobile operating system software and services. These systems integrators are given substantially the same access by Microsoft to the Microsoft technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the connected device market, and as new products and technologies are introduced.

International Operations

Our international operations outside of North America consist principally of operations in Taipei, Taiwan and Trowbridge, England. We have a sales and sales support office in Tokyo, Japan. Because our OEM Distribution

Agreement with Microsoft for the sale of Microsoft Windows Embedded operating systems (e.g. Windows Embedded Compact) has been, until relatively recently, restricted to North America, including Mexico, the majority of our revenue continues to be generated from North America. In 2014, revenue generated from customers located outside of North America was 10% of total revenue, compared to 13% in 2013. The decrease in non-North American revenue in 2014 was primarily attributable to lower sales of Windows Mobile operating systems, lower service revenue and lower proprietary software sales in Asia.

See Item 1A, "Risk Factors," and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," for more information regarding our international operations.

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Personnel

The following indicates the total headcount by area:

| | December 31, 2014 2013 | |
|--|------------------------------|-----|
| Engineering Services | 124 | 119 |
| Sales, Marketing and Administrative | 52 | 56 |
| Research and Product Development | 7 | 12 |
| Total Employees | 183 | 187 |
| Contractors (primarily engineering services) | 14 | 18 |
| Total Headcount | 197 | 205 |

Of the total headcount of 197 at December 31, 2014, 112 were located in North America, 47 in Taiwan, 36 in the United Kingdom and 2 in Japan. As conditions necessitate, engineering service employees perform research and development activities and vice versa. In October 2013, we effected a headcount reduction that impacted approximately 20% of our worldwide workforce.

Intellectual Property and Other Proprietary Rights

In general, we strive to protect our intellectual property rights through patent, copyright, trademark and trade secret laws and through contractual arrangements. However, we cannot be certain that our efforts will be effective to prevent the misappropriation of our intellectual property, or to prevent the development and design by others of products or technologies similar to, or competitive with, those developed by us.

Additionally, because a significant portion of our revenue relates to the sale of third-party software products, we also rely on our partners, particularly Microsoft, to appropriately protect their own intellectual property.

As of December 31, 2014 we have eight issued United States (“US”) patents and one pending US patent application. We also have a number of registered trademarks in various jurisdictions. We will continue to pursue appropriate protections for our intellectual property.

See Item 1A, “Risk Factors,” for more information regarding our intellectual property and other proprietary rights.

Available Information

We electronically file with the Securities and Exchange Commission (“SEC”) our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. We make available on our website at www.bsquare.com, free of charge, copies of these reports, as soon as reasonably practicable after electronically filing such reports with, or furnishing them to, the Securities and Exchange Commission. The information contained in, or that can be accessed through, our website is not part of, and is not incorporated into, this Annual Report on Form 10-K.

Directors and Executive Officers of the Registrant

The following table sets forth certain information with respect to our directors and executive officers as of January 31, 2015:

| Name | Age | Position |
|--------------------------|-----|---|
| Andrew S. G. Harries | 52 | Chairman of the Board |
| Jerry D. Chase | 55 | President and Chief Executive Officer; Director |
| Elliott H. Jurgensen, Jr | 70 | Director |
| Harel Kodesh | 56 | Director |
| William D. Savoy | 50 | Director |
| Kendra A. VanderMeulen | 63 | Director |
| Mark D. Whiteside | 52 | Vice President, Solutions |
| Martin L. Heimbigner | 56 | Chief Financial Officer |
| Scott B. Caldwell | 46 | Vice President, Worldwide OEM Sales |

Item 1A. Risk Factors.

As discussed under Item 1 of Part I, “Business—Cautionary Note Regarding Forward-Looking Statements,” our actual results could differ materially from those expressed in our forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed below. Additional risks and uncertainties not presently known to us, or that

we currently deem immaterial, may also impair our business operations. If any of the following risks occur, our business, financial condition, operating results, cash flows and the trading price of our common stock could be materially adversely affected.

Microsoft-Related Risk Factors

Due to the fact that we provide software and services to customers building devices utilizing Microsoft's Windows Embedded and Windows Mobile operating systems, as well as the fact that a significant portion of our revenue is derived from the sale of Microsoft Windows Embedded and Windows Mobile operating systems, Microsoft has a significant direct and indirect influence on our business. The following Microsoft-related risk factors may negatively impact our business and operating results.

If we do not maintain our OEM Distribution Agreements with Microsoft or if Microsoft de-emphasizes or divests itself from these areas of its business, our revenue would decrease and our business would be adversely affected.

We have OEM Distribution Agreements ("ODAs") for Software Products for Embedded Systems with Microsoft, which enable us to sell various Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba), Mexico, the European Union and the European Free Trade Association. These ODAs are effective through June 30, 2016. We have also entered into other ODAs with Microsoft pursuant to which we are licensed to sell Microsoft Windows Mobile operating systems to customers in North America, South America, Central America (excluding Cuba), Japan, Taiwan, Europe, the Middle East, and Africa. The ODAs to sell Windows Mobile operating systems are effective through June 30, 2015.

We generated \$70.2 million and \$64.0 million of revenue in 2014 and 2013, respectively, through our sales of Microsoft operating systems and expect this revenue stream to continue in 2015. If any of the ODAs are terminated by Microsoft (which Microsoft can do unilaterally) or not renewed, or if Microsoft decides to no longer invest in or to divest itself from these areas of its business, our software revenue and resulting gross profit could decrease significantly and our operating results would be negatively impacted. Future renewals, if any, could be on less favorable terms, which could also negatively impact our business and operating results.

Microsoft can change pricing under the ODAs at any time, and unless we are able to either pass through price increases to our customers or sign our customers to 12-month purchasing commitments, which lowers the price we pay to Microsoft, our revenue, gross profit and operating results would be negatively impacted. Further, Microsoft currently offers a rebate program in conjunction with our ODA activities in which we earn money for achieving certain predefined objectives. If Microsoft were to eliminate or negatively modify the rebate program, our gross profit and operating results would be negatively impacted. We qualified for rebate credits from Microsoft of \$1.0 million and \$1.2 million in 2014 and 2013, respectively, a portion of which is accounted for as a reduction in cost of sales and a portion as a reduction in marketing expense if and when qualified expenditures are made.

Microsoft has audited our records under the ODAs in the past and will likely audit our records again in the future and any negative audit results could result in additional charges and/or the termination of the ODAs.

There are provisions in the ODAs that require us to maintain certain internal records and processes for auditing and other reasons. Non-compliance with these and other requirements could result in the termination of the ODAs. Microsoft has concluded audits of our records pertaining to the ODAs in 2009 and 2006, neither of which had material findings. It is possible that future audits could result in charges due to any material findings that are found. The provisions also include terms that may make us contractually liable for payment of royalties to Microsoft in the event that certificates of authenticity are lost, damaged or stolen.

If we are invoiced by Microsoft for a pricing adjustments under OVRP arrangements and we are unable to pass through the charge to our customers, our operating results and cash flow would be negatively impacted.

In conjunction with our activities under the ODAs with Microsoft, we enter into OEM Volume Royalty Program (“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 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. While our history with OVRP arrangements has shown that very few result in a price adjustment and, for those that have, we have been able to pass through the price adjustment to our customer, in the event the customer is unwilling or unable to pay us, our operating results and cash flow would be negatively impacted.

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

We maintain a strategic marketing relationship with Microsoft. If our relationship with Microsoft deteriorates for any reason, such as an increased focus by us on customers building devices utilizing non-Microsoft operating systems, our efforts to market and sell our software and services to our customers could be adversely affected and our business could be harmed. Microsoft has significant influence over the development plans and buying decisions of customers utilizing the various Microsoft Windows Embedded and Windows Mobile operating systems. Microsoft provides customer referrals to us. Moreover, Microsoft controls the marketing campaigns related to its operating systems. Microsoft's marketing activities are important to the continued promotion and market acceptance of Microsoft Windows Embedded and Windows Mobile operating systems and, consequently, to our sale of Windows-based software and services. We must maintain a favorable relationship with Microsoft to continue to participate in joint marketing activities with them, which includes participating in "partner pavilions" at trade shows, listing our services on Microsoft's website, and receiving customer referrals. If we are unable to continue our joint marketing efforts with Microsoft, or fail to receive referrals from them, we would be required to devote significant additional resources and incur additional expenses to market our software products and services directly to potential customers. In addition, we depend on Microsoft for developer releases of new versions of, and upgrades to, its Windows Embedded and Windows Mobile software in order to facilitate timely development and delivery of our own software and services. If we are unable to maintain our favorable relationship with Microsoft and no longer continue receiving such new versions and updates, our revenue could decline significantly, and/or our costs could increase significantly, thereby negatively impacting our operating results.

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

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

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

As the developer of Windows Embedded and Windows Mobile operating systems, Microsoft could add features which eliminate or reduce our customers' need for our software and services, or Microsoft could develop standalone products and services that compete with the products and services we provide to our customers. The ability of our customers, or potential customers, to obtain products and services directly from Microsoft that compete with our products and services could negatively impact our revenue and operating results. Even if the standard features of future Microsoft operating system software were more limited than our offerings, a significant number of our customers, and potential customers, might elect to accept more limited functionality in lieu of purchasing additional software from us or delay the purchase of our products and services while they perform a comparison of Microsoft's competing offerings. Moreover, the resulting competitive pressures could lead to price reductions for our offerings and reduce our revenue and gross profit accordingly and our operating results could be negatively impacted.

Our business and results of operations would be adversely impacted if Microsoft decided to provide some, or all, of its Windows Embedded or Windows Mobile operating systems which we currently resell, free of charge to customers.

Microsoft has recently announced programs to offer certain consumer Windows phone and tablet-based operating systems to customers free of charge, subject to certain limitations. While we do not distribute these operating systems

today under our ODA with Microsoft, if Microsoft were to pursue a similar strategy and offer operating systems that we do currently distribute free of charge, our business and results of operations would be adversely impacted.

Microsoft will be introducing the Windows 10 operating system software in the near future, and Microsoft's pricing and support for this new operating system could directly impact our revenue and margins.

In January 2015, Microsoft announced a new operating system, Windows 10, but has not indicated when the software will be available to customers. Microsoft indicated that Windows 10 will be delivered as a service which may alter the traditional business model used to sell Microsoft licenses as a software product. As a reseller of Microsoft Windows Embedded and Windows Mobile operating systems, changes Microsoft's business model may adversely impact our revenue and gross profit and our operating results could be negatively impacted.

If the markets for Windows Embedded and/or Windows Mobile operating systems decline, our business and operating results may be materially harmed.

Because a significant portion of our revenue to date has been generated by software and services targeted at customers and devices utilizing the various Microsoft Windows Embedded and Windows Mobile operating systems, if the markets for these systems or platforms decline, our business and operating results could be negatively impacted. Market acceptance of Microsoft Windows Embedded and Windows Mobile operating systems will depend on many factors, including:

- Microsoft's development and support of various Windows Embedded and Windows Mobile markets. As the developer and primary promoter of several versions of operating systems aimed at Windows Embedded and Windows Mobile markets, if Microsoft were to decide to discontinue or lessen its support of these operating systems and platforms, potential customers could select competing operating systems, which could reduce the demand for our Microsoft Windows Embedded and Windows Mobile related software products and engineering services, from which a significant portion of our revenue is generated today;
- The ability of the Microsoft Windows Embedded and/or Windows Mobile operating systems to compete against existing and emerging operating systems for the smart connected systems market, including: iOS from Apple, Inc., VxWorks and Linux from WindRiver Systems Inc.; Android from Google Inc.; QNX; Blackberry from Research In Motion Limited ("RIM"); and other proprietary operating systems. Microsoft Windows Embedded and Windows Mobile operating systems may be unsuccessful in capturing a significant share of the smart connected systems market, or in maintaining its market share;
- The acceptance by customers of the mix of features and functions offered by Microsoft Windows Embedded and Windows Mobile operating systems; and
- The willingness of software developers to continue to develop and expand the applications running on Microsoft Windows Embedded and Windows Mobile operating systems. To the extent that software developers write applications for competing operating systems that are more attractive to users than those available on Microsoft Windows Embedded and Windows Mobile operating systems, this could cause potential customers to select competing operating systems.

MyFord Touch-Related Risk Factors

If we do not obtain additional work on the MyFord Touch program, our future revenue and gross profit would decrease and our operating results would be adversely affected.

We began working on the MyFord Touch infotainment project with Ford in the second quarter of 2008 and continue to work on the program. Since inception of the program through December 31, 2011, our contractual relationship was with Ford. Effective January 1, 2012, our contractual relationship for the MyFord Touch program shifted from Ford to Microsoft, as Microsoft has become the primary vendor to Ford for this program. In 2014 the relationship added Elektrobit Automotive. In December 2014, Ford introduced Sync 3, the next generation MyFord Touch program that is scheduled to be deployed on cars in 2016 and will be based on QNX software from Blackberry instead of software from Microsoft.

Revenue from the MyFord Touch program comprised \$2.8 million, or 3%, of our total revenue in 2014, and \$4.5 million, or 5%, of our total revenue in 2013. We currently expect this project work to continue in 2015 but expect revenue from the MyFord Touch program to be lower, albeit still significant in 2015, than it was in 2013 due to the lower level of personnel resources utilized on the program. Our statements of work with Microsoft and Ford currently run through June 30, 2015, and with Elektrobit through December 31, 2015. While we expect to be actively involved in current generation MyFord Touch projects with Microsoft, Ford and Elektrobit through 2015 and beyond, we expect our role on MyFord Touch will be scaled back or eliminated because of the transition to QNX software for the next generation Sync 3 and our revenue and resulting gross profit will decline accordingly.

General Business-Related Risk Factors

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

The market for device software and services is extremely competitive. We face competition from the following:

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