BSQUARE CORP /WA
Form 10-Q
May 15, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2017

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 (State or other jurisdiction of incorporation or organization)	91-1650880 (I.R.S. Employer Identification No.)
110 110th Avenue NE, Suite 300, Bellevue WA (Address of principal executive offices)	98004 (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 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares of common stock outstanding as of April 28, 2017: 12,569,043

BSQUARE CORPORATION

FORM 10-Q

For the Quarterly Period Ended March 31, 2017

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	March 31, 2017 (Unaudited)	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,704	$ 14,312
Short-term investments	21,280	18,888
Accounts receivable, net of allowance for doubtful accounts of $50 at March 31, 2017 and December 31, 2016	15,751	21,579
Prepaid expenses and other current assets	1,474	878
Contract assets	883	—
Total current assets	49,092	55,657
Equipment, furniture and leasehold improvements, net	1,040	1,089
Deferred tax assets	7	7
Intangible assets, net	439	464
Goodwill	3,738	3,738
Other non-current assets including contract assets	87	53
Total assets	$ 54,403	$ 61,008
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Third-party software fees payable	$ 9,111	$ 14,831
Accounts payable	372	283
Accrued compensation	1,786	2,008
Other accrued expenses	806	714
Deferred rent, current portion	327	321
Deferred revenue	1,908	2,064
Total current liabilities	14,310	20,221
Deferred tax liability	—	23
Deferred rent	772	854
Deferred revenue	115	1,798
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; 12,568,708 shares issued and outstanding at March 31, 2017 and 12,532,348 shares issued and outstanding at December 31, 2016	136,150	135,660
Accumulated other comprehensive loss	(928)	(941)
Accumulated deficit	(96,016)	(96,607)
Total shareholders’ equity	39,206	38,112
Total liabilities and shareholders’ equity	$ 54,403	$ 61,008

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

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

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
Revenue:		
Software	$19,451	$20,167
Professional engineering service	3,390	5,272
Total revenue	22,841	25,439
Cost of revenue:		
Software	14,114	17,161
Professional engineering service	2,474	3,982
Total cost of revenue	16,588	21,143
Gross profit	6,253	4,296
Operating expenses:		
Selling, general and administrative	4,865	3,206
Research and development	1,347	441
Total operating expenses	6,212	3,647
Income from operations	41	649
Other income, net	55	21
Income before income taxes	96	670
Income tax benefit (expense)	106	(170)
Net income	$202	$500
Basic income per share	$0.02	$0.04
Diluted income per share	$0.02	$0.04
Shares used in calculation of income per share:		
Basic	12,550	12,102
Diluted	12,848	12,531
Comprehensive income:		
Net income	$202	$500
Other comprehensive income:		
Foreign currency translation, net of tax	(7)	21
Change in unrealized gains (losses) on investments, net of tax	5	(25)
Total other comprehensive income	(2)	(4)
Comprehensive income	$200	$496

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Three Months Ended March 31,	
	2017	2016
Cash flows from operating activities:		
Net income	$202	$500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	153	151
Stock-based compensation	399	413
Changes in operating assets and liabilities:		
Accounts receivable, net	5,078	(2,314)
Contract assets, current	203	—
Prepaid expenses and other assets	(617)	(30)
Third-party software fees payable	(5,720)	256
Accounts payable and accrued expenses	(41)	(624)
Deferred revenue	(1,804)	(393)
Deferred rent	(76)	(71)
Net cash used in operating activities	(2,223)	(2,112)
Cash flows from investing activities:		
Purchases of equipment and furniture	(83)	(38)
Proceeds from maturities of short-term investments	9,750	6,450
Purchases of short-term investments	(12,146)	(8,438)
Net cash used in investing activities	(2,479)	(2,026)
Cash flows provided by financing activities—proceeds from exercise of stock options	91	58
Effect of exchange rates on cash	3	(21)
Net decrease in cash and cash equivalents	(4,608)	(4,101)
Cash and cash equivalents, beginning of period	14,312	16,443
Cash and cash equivalents, end of period	$9,704	$12,342

See notes to condensed consolidated financial statements.

BSQUARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2017

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of BSQUARE Corporation ("BSQUARE") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting and include the accounts of BSQUARE and our wholly owned subsidiaries. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to such rules and regulations. In our opinion, the unaudited condensed consolidated financial statements include all material adjustments, all of which are of a normal and recurring nature, necessary to present fairly our financial position as of March 31, 2017, our operating results for the three months ended March 31, 2017 and 2016 and our cash flows for the three months ended March 31, 2017 and 2016. The accompanying financial information as of December 31, 2016 is derived from audited financial statements. Preparing financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include provisions for bad debts and income taxes, estimates of progress on professional engineering service arrangements and bonus accruals. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2016. All intercompany balances have been eliminated.

Recently Adopted Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") amended the existing accounting standards for stock-based compensation by issuing Accounting Standards Update ("ASU") 2016-09 "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). The changes in the new standard eliminate the requirements that excess tax benefits be recognized in additional paid-in capital and tax deficiencies be recognized either in the income tax provision or in additional paid-in capital, in addition to changing the accounting for forfeitures and presentation changes for cash flows. We adopted the amendments in the first quarter of 2017.

ASU 2016-09 requires that certain amendments be applied using a modified retrospective transition method by means of a cumulative effect adjustment to retained earnings as of the beginning of 2017. As a result of this adoption, we adjusted beginning retained earnings by $3,200 at the beginning of 2017 for amendments related to an entity-wide accounting policy election to recognize share-based award forfeitures as they occur rather than at vest date. We will continue to apply an estimated forfeiture rate. There was no change to retained earnings with respect to unrecognized excess tax benefits as this was not applicable to us. We have elected to present any excess tax benefits for share-based payments in net operating cash rather than in net financing cash on the cash flow statement on a prospective transition method, and no prior periods have been adjusted.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers," amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The amended guidance, herein referred to as Topic 606, is effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted for public companies effective for annual and interim reporting periods beginning after December 15, 2016. We have elected to early adopt Topic 606, effective January 1, 2017, using the modified retrospective transition method. We recognized the cumulative effect of applying the new revenue standard as an adjustment to the opening balance of retained earnings at the beginning of 2017. The comparative information has not been restated and continues to be reported under the accounting standards in effect for the period presented.

See Note 2 – Revenue Recognition, for additional accounting policy and transition disclosures.

Recently Issued Accounting Standards

In February 2016, the FASB issued ASU No. 2016-2, "Leases," to make leasing activities more transparent and comparable, requiring most leases be recognized by lessees on their balance sheets as right-of-use assets, along with corresponding lease liabilities. ASU 2016-2 is effective for public business entities for annual periods beginning after December 31, 2018 and interim periods within that year, with early adoption permitted. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," adding or clarifying guidance on the classification of certain cash receipts and payments in the statement of cash flows. The standard addresses eight specific cash flow issues with the objective of reducing diversity in practice. ASU 2016-15 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," simplifying how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. ASU 2017-04 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, with early adoption permitted on testing dates after January 1, 2017. We are currently evaluating the impact this ASU may have on our consolidated financial statements and related disclosures.

Income Per Share

We compute basic income per share using the weighted average number of common shares outstanding during the period, and exclude any dilutive effects of common stock equivalent shares, such as options, restricted stock awards and restricted stock units. We consider restricted stock awards ("RSAs") as outstanding and include them in the computation of basic income per share when underlying restrictions expire and the awards are no longer forfeitable. We consider restricted stock units ("RSUs") as outstanding and include them in the computation of basic income per share only when vested. We compute diluted income per share using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock method. We exclude common stock equivalent shares from the computation if their effect is anti-dilutive.

We excluded 1,160,015 options for the three months ended March 31, 2017 from diluted income per share because their effect was anti-dilutive. In a period where we are in a loss position, we compute diluted loss per share using the basic share count. We excluded 633,309 options for the three months ended March 31, 2016 from diluted income per share because their effect was anti-dilutive.

2. Revenue Recognition

On January 1, 2017, we adopted Topic 606 applying the modified retrospective method to all contracts that were not completed as of January 1, 2017. Results for reporting periods beginning after January 1, 2017 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. We recorded a net reduction to opening equity of $404,000 as of January 1, 2017 due to the cumulative impact of adopting Topic 606. The impact to revenues for the three months ended March 31, 2017 was an increase of $2.8 million as a result of adopting Topic 606.

The adoption of Topic 606 did not have a significant impact on our third-party software or professional engineering services revenue; however, it did have a significant impact on our proprietary DataV software products. We executed our first two DataV contracts in the fourth quarter of 2016. Our current DataV contracts include customization, software license and support and maintenance performance obligations. Under the accounting standards in effect in the prior period, revenues from our DataV software contracts were recognized under a zero profit model whereby revenue was recognized up to the amount of costs incurred. The profit margin was deferred and recognized ratably over the service and maintenance period after delivery and acceptance of the software product. Under Topic 606, revenue is recognized on our DataV contracts when the customization services essential to provide the derived benefit of the software to the customer are completed and control of the product is transferred to the customer as evidenced by customer acceptance. During the three month period ended March 31, 2017, we received customer acceptance on a DataV software license, resulting in the recognition of $2.8 million in revenue for the software license and customization services.

Changes in accounting policies as a result of adopting Topic 606 and nature of goods

The following is a description of principal activities from which we generate revenue. Revenues are recognized when control of the promised goods or services are transferred to our customers, in an amount that reflects the consideration that we expect to receive in exchange for those goods or services. We generate all of our revenue from contracts with customers.

Third-Party Software:

We sell third-party software licenses based upon a customer purchase order, shipping a certificate of authenticity (“COA”) to satisfy this single performance obligation. These shipments are also subject to limited return rights; historically, returns have averaged less than one-quarter of one percent. In accordance with Topic 606, we will continue to recognize revenue from third-party products at the time of shipment when the customer accepts control of the COA.

Proprietary Software:

We sell our proprietary software products to customers under a contract or by purchase order. Our DataV software contracts generally include professional services, a perpetual or term license and support and maintenance. In contracts with multiple performance obligations, we identify each performance obligation and evaluate whether the performance obligations are distinct within the context of the contract at contract inception. Performance obligations that are not distinct at contract inception are combined. Contracts that include software customization may result in the combination of the customization services with the software license as one distinct performance obligation. The transaction price is generally in the form of a fixed fee at contract inception. Certain DataV contracts also include variable consideration in the form of royalties earned when customers meet contractual volume thresholds. We allocate the transaction price to each distinct performance obligation based on the estimated standalone selling price for each performance obligation. We then look to how control transfers to the customer in order to determine the timing of revenue recognition. In contracts that include customer acceptance, we recognize revenue when we have delivered the software and received customer acceptance. We recognize revenues from support and maintenance performance obligations over the service delivery period. We recognize revenues from royalties in the period of usage.

Our non-DataV software products generally do not include customization or modification services and are sold in the form of term licenses. These software licenses represent one performance obligation. Revenue is recognized when the software is delivered to the customer.

There are two items involving revenue recognition on DataV software contracts that require us to make more difficult and subjective judgments: the determination of which performance obligations are distinct within the context of the overall contract and the estimated standalone selling price of each performance obligation. In instances where our DataV contracts include significant customization or modification services, the customization and modification services are generally combined with the software license and recorded as one distinct performance obligation. We estimate the standalone selling price of each performance obligation based on either a cost plus margin approach or an adjusted market assessment approach. In instances where we have observable selling prices for professional services and support and maintenance, we may apply the residual approach to estimate the standalone selling price of software licenses.

Professional Engineering Services

We enter into contracts for professional engineering services that include software development and customization. We identify each performance obligation in our professional engineering services contracts at contract inception. The contracts generally include project deliverables specified by each customer. The performance obligations in the agreements are generally combined into one deliverable. The contract pricing is either at stated billing rates per service hour and material costs or at a fixed amount. Services provided under professional engineering agreements generally result in the transfer of control over time. The underlying deliverable is owned and controlled by the customer and does not create an asset with an alternative use to us. We recognize revenue on service contracts based on time and materials as we have the right to invoice. We recognize revenue on fixed fee contracts on the proportion of labor hours expended to the total hours expected to complete the contract performance obligation. Certain professional engineering contracts include substantive customer acceptance provisions. In contracts that include substantive customer acceptance provisions, we recognize revenue upon customer acceptance.

The determination of the total labor hours expected to complete the performance obligations involves significant judgment. In certain situations, when it is impractical for us to reasonably measure the outcome of a performance obligation, and where we anticipate that we will not incur a loss, an adjusted cost based input method is used for revenue recognition. Equal amounts of revenue and cost are recognized during the contract period, and profit is recognized when the project is completed and accepted.

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Disaggregation of revenue:

The following table provides information about disaggregated revenue by primary geographical market, major product line and timing of revenue recognition, and includes a reconciliation of the disaggregated revenue with reportable segments (in thousands):

	Three Months Ended March 31, 2017				
	Third Party Software	Proprietary Software	Total Software	Professional Engineering Services	Total
Primary geographical markets					
North America	$16,296	$ 2,645	$ 18,941	$ 2,829	$21,770
Europe	424	—	424	398	822
Asia	77	9	86	163	249
Total	$16,797	$ 2,654	$ 19,451	$ 3,390	$22,841
Major products/services lines					
Third-party software	$16,797	$ —	$ 16,797	$ —	$16,797
Proprietary software	—	2,654	2,654	—	2,654
Professional engineering services	—	—	—	3,390	3,390
	$16,797	$ 2,654	$ 19,451	$ 3,390	$22,841
Timing of revenue recognition					
Products transferred at a point in time	$16,797	$ 2,654	$ 19,451	$ 590	$20,041
Products and services transferred over time	—	—	—	2,800	2,800
	$16,797	$ 2,654	$ 19,451	$ 3,390	$22,841

Contract balances:

The following table provides information about receivables, contract assets and contract liabilities from contracts with customers (in thousands):

	As of March 31, 2017
Receivables	$15,751
Short-term contract assets	883
Long-term contract assets	31
Short-term contract liabilities (deferred revenue)	1,908
Long-term contract liabilities (deferred revenue)	115

We receive payments from customers based upon contractual billing schedules; accounts receivable are recorded when the right to consideration becomes unconditional. Contract assets include amounts related to our contractual right to consideration for completed performance objectives not yet invoiced, and also includes deferred contract acquisition costs, which will be amortized along with the associated revenue. Contract liabilities include payments received in advance of performance under the contract, and are realized with the associated revenue recognized under the contract. We had no asset impairment charges related to contract assets in the period.

Significant changes in the contract assets and the contract liabilities balances during the period are as follows (in thousands):

	Three Months Ended March 31, 2017	
	Contract Assets	Contract Liabilities*
Revenue recognized that was included in the contract liability (def. revenue) balance at Jan. 1, 2017	$—	$ 2,627
Increases due to cash received, excluding amounts recognized as revenue during the period	—	929
Transferred to receivables from contract assets recognized at January 1, 2017	752	—
Performance obligations satisfied in previous periods	—	—

* Comprised of Deferred Revenue

Contract acquisition costs:

In connection with the adoption of Topic 606, we are required to capitalize certain contract acquisition costs consisting primarily of commissions paid when contracts are signed. As of January 1, 2017, the date we adopted Topic 606, we capitalized $292,000 in contract acquisition costs related to contracts that were not completed. For contracts that have a duration of less than one year, we follow a Topic 606 practical expedient and expense these costs when incurred; for contracts with life exceeding one year, as is more common with our DataV software bookings, we record these costs in proportion to each completed contract performance obligation. In the three months ended March 31, 2017, the amount of amortization was $141,000 and there was no impairment loss in relation to costs capitalized.

Transaction price allocated to the remaining performance obligations

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The estimated revenues do not include amounts of variable consideration attributable to royalties or unexercised contract renewals (in thousands):

	Remainder of 2017	2018	2019
Third-party software	$ 109	$110	$36
Proprietary software	1,794	470	196
Professional engineering services	246	—	—

Practical Expedients and Exemptions

We generally expense sales commissions when incurred because the amortization period would have been less than one year. We record these costs within selling, general and administrative expenses.

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In accordance with Topic 606, the disclosure of the impact of adoption to our condensed consolidated statements of income and balance sheets was as follows:

	Three months ended March 31, 2017 Impact of changes in accounting policies		
(in thousands, except per share amounts)	As Reported	Balances without adoption of Topic 606	Effect of Change Higher/(Lower)
Revenue:			
Software	$19,451	$17,138	$ 2,313
Professional engineering service	3,390	2,944	446
Total revenue	22,841	20,082	2,759
Cost of revenue:			
Software	14,114	14,114	—
Professional engineering service	2,474	2,150	324
Total cost of revenue	16,588	16,264	324
Gross profit	6,253	3,818	2,435
Operating expenses:			
Selling, general and administrative	4,865	4,724	141
Research and development	1,347	1,347	—
Total operating expenses	6,212	6,071	141
Income from operations	41	(2,253)	2,294
Net income (loss)	$202	$(2,092)	$ 2,294
Basic income(loss) per share	$0.02	$(0.17)	$ 0.19
Diluted income (loss) per share	$0.02	$(0.17)	$ 0.19