BSQUARE CORP /WA
Form 10-Q
November 12, 2008

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

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from __________ to __________

Commission File Number: 000-27687

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

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

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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

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

The number of shares of common stock outstanding as of October 31, 2008: 10,053,761

BSQUARE CORPORATION
FORM 10-Q
For the Quarterly Period Ended September 30, 2008
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

BSQUARE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	September 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,158	$ 4,377
Short-term investments	625	9,575
Accounts receivable, net of allowance for doubtful accounts of $198 at September 30, 2008 and $199 at December 31, 2007	10,310	8,273
Prepaid expenses and other current assets	611	377
Total current assets	20,704	22,602
Long-term investments	5,434	
Equipment, furniture and leasehold improvements, net	1,042	824
Intangible assets, net	163	230
Restricted cash	900	1,050
Other non-current assets	74	56
Total assets	$ 28,317	$ 24,762
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,527	$ 2,619
Other accrued expenses	2,874	2,877
Accrued compensation	1,782	1,393
Accrued legal fees	534	534
Deferred revenue	522	493
Total current liabilities	8,239	7,916
Deferred rent	313	331
Commitments and contingencies (Note 6)		
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; 10,051,800 shares issued and outstanding at September 30, 2008 and 9,967,618 shares issued and outstanding at December 31, 2007	122,319	121,118

Accumulated other comprehensive loss	(857)	(409)
Accumulated deficit	(101,697)	(104,194)
Total shareholders equity	19,765	16,515
Total liabilities and shareholders equity	$ 28,317	$ 24,762

See notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue:				
Software	$ 8,716	$ 8,951	$ 29,392	$ 28,328
Service	7,486	4,653	19,294	15,466
Total revenue	16,202	13,604	48,686	43,794
Cost of revenue:				
Software	6,747	6,692	22,819	21,451
Service (1)	5,022	3,429	13,008	11,356
Total cost of revenue	11,769	10,121	35,827	32,807
Gross profit	4,433	3,483	12,859	10,987
Operating expenses:				
Selling, general and administrative (1)	3,006	2,614	8,998	8,214
Research and development (1)	622	573	1,827	1,716
Total operating expenses	3,628	3,187	10,825	9,930
Gain on sale of patents	300		300	
Income from operations	1,105	296	2,334	1,057
Interest and other income	58	152	306	719
Income before income taxes	1,163	448	2,640	1,776
Income tax expense	(16)	(89)	(143)	(237)
Net income	$ 1,147	$ 359	$ 2,497	$ 1,539
Basic income per share	$ 0.11	$ 0.04	$ 0.25	$ 0.16
Diluted income per share	$ 0.11	$ 0.03	$ 0.24	$ 0.15
Shares used in the calculation of income per share:				
Basic	10,039	9,908	10,009	9,803
Diluted	10,103	10,359	10,251	10,155

(1) Includes the following

amounts related to non-cash stock-based compensation expense:				
Cost of revenue service	$ 94	$ 100	$ 321	$ 208
Selling, general and administrative	250	234	717	524
Research and development	14	23	59	56
Total stock-based compensation expense	$ 358	$ 357	$ 1,097	$ 788

See notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities:		
Net income	$ 2,497	$ 1,539
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized gain on sale of patents	(300)	
Depreciation and amortization	403	389
Stock-based compensation	1,097	788
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,741)	(1,777)
Prepaid expenses and other assets	(251)	59
Accounts payable and accrued expenses	298	453
Deferred revenue	30	709
Deferred rent	(18)	(18)
Net cash provided by operating activities	2,015	2,142
Cash flows from investing activities:		
Purchases of equipment and furniture	(557)	(334)
Proceeds from reduction of restricted cash	150	150
Purchases of investments		(568)
Maturities of investments	3,050	
Net cash provided by (used in) investing activities	2,643	(752)
Cash flows from financing activities:		
Proceeds from exercise of stock options	104	766
Net cash provided by financing activities	104	766
Effect of exchange rate changes on cash	19	(13)
Net increase in cash and cash equivalents	4,781	2,143
Cash and cash equivalents, beginning of period	4,377	2,483
Cash and cash equivalents, end of period	$ 9,158	$ 4,626

See notes to condensed consolidated financial statements.

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BSQUARE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2008
(unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by BSQUARE Corporation (the Company or BSQUARE) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting and include the accounts of the Company 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 reflect all material adjustments, which consist solely of normal recurring adjustments, necessary to present fairly the Company s financial position as of September 30, 2008 and its operating results and cash flows for the three and nine months ended September 30, 2008 and 2007. The accompanying financial information as of December 31, 2007 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 provision for bad debts and income taxes and estimates of progress on professional 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, 2007 filed with the SEC. All intercompany balances have been eliminated.

Earnings Per Share

Basic earnings 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 stock options. Diluted earnings per share is computed using the weighted average number of common shares outstanding and common stock equivalent shares outstanding during the period using the treasury stock method. Common stock equivalent shares are excluded from the computation if their effect is antidilutive. Common stock equivalent shares were 2,084,676 at September 30, 2008 and 969,537 at September 30, 2007.

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Weighted average shares outstanding for basic earnings per share	10,039	9,908	10,009	9,803
Dilutive effect of common stock equivalent shares	64	451	242	352
Weighted average shares outstanding for diluted earnings per share	10,103	10,359	10,251	10,155

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2. Investments

The Company s investments consist of auction rate securities, or ARS. ARS are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are 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 holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed.) These investments are illiquid and the Company is unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is contingent on redemption of the investments by the issuers, settlement by the underwriters as further described below or sales of the securities in a secondary market. Failed ARS that the Company held with a par value of $2,250,000 were redeemed by their issuers at par during the nine months ended September 30, 2008. This redeemed amount represents 26% of the Company s ARS portfolio balance immediately following the ARS market failure in February 2008. The New York Attorney General has recently announced settlements with large investment banks, whereby the underwriters of ARS will repurchase certain illiquid ARS from its current customers. The Company is not a current customer of any of the investment banks that have agreed to settlements and is therefore uncertain whether any of its ARS will be repurchased. ARS are currently being sold on the secondary market at discounts that range from 8% to 30% depending on the type of security. The Company s ARS have AAA ratings and continue to pay interest according to the stated terms.

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS No. 157) as of January 1, 2008 to measure the fair value of its ARS. Under SFAS No. 157, based on the observability of the inputs used in the valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

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.

In October 2008, the FASB issued Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP 157-3). FSP 157-3 clarifies the application of SFAS No. 157 to financial assets for which an active market does not exist. Specifically, FSP 157-3 addresses the following SFAS No. 157 application issues:

a. How the reporting entity s own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist.

b. How available observable inputs in a market that is not active should be considered when measuring fair value.

c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

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FSP 157-3 applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurement in accordance with SFAS No. 157. The Company evaluated a number of factors, including a third-party valuation of its ARS as of September 30, 2008 and has determined the fair value to be $6,059,000 as compared to par value of $6,525,000. As a result, the Company recorded an unrealized loss on investments of $466,000 for the three months ended September 30, 2008. Although the Company is uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be temporary. In addition, the Company has the intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in market value. Therefore, this unrealized loss is not included in earnings, but is reflected in other comprehensive income within shareholders equity. It is possible that additional declines in fair value may occur in the future. If general economic conditions worsen or specific factors used in determining fair value deteriorate, the Company may further adjust the carrying value of these investments.

During October 2008, ARS with a par value of $625,000 were redeemed at par by their issuers. The Company has classified this amount as short-term investments as of September 30, 2008. The remaining $5.4 million in ARS has been classified as long-term investments due to the uncertainty in when these investments will be liquidated.

Fair value measurements of the Company s ARS as of September 30, 2008 were as follows:

	Fair Value Measurements as of September 30, 2008 Using:			
	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	$	$	$ 3,883	$ 3,883
Closed-end funds			1,917	1,917
Corporate collateral			259	259
Total auction rate securities	$	$	$ 6,059	$ 6,059
Amounts included in:				
Short-term investments	$	$	$ 625	$ 625
Long-term investments			5,434	5,434
Total	$	$	$ 6,059	$ 6,059

The following table reconciles the beginning and ending balances for auction rate securities using significant unobservable inputs (Level 3):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3):	
	Closed-end	**Corporate**

	Student Loan Backed	Funds	Collateral	Total
		(in thousands)		
Balance at June 30, 2008	$ 4,050	$ 1,975	$ 500	$ 6,525
Unrealized losses included in other comprehensive income	(167)	(58)	(241)	(466)
Balance at September 30, 2008	$ 3,883	$ 1,919	$ 259	$ 6,059

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3. Intangible Assets

Intangible assets relate to technology and other assets acquired from NEC Corporation of America in December 2007.

	September 30, 2008	December 31, 2007
Gross carrying value of the acquired intangible assets subject to amortization	$ 230	$ 230
Less: Accumulated amortization	67	
Net book value	$ 163	$ 230

Amortization expense was $22,000 for the three months ended September 30, 2008 and zero for the three months ended September 30, 2007. Amortization expense was $67,000 for the nine months ended September 30, 2008 and $101,000 for nine months ended September 30, 2007. Amortization expense in 2007 related to technology acquired from Vibren Technologies, Inc. in June 2005. These assets were fully amortized as of June 30, 2007. Amortization expense is expected to be $22,000 for the remainder of 2008.

4. Stock-Based Compensation

Stock Options

In May 1997, the Company adopted a Stock Option Plan, which has subsequently been amended and restated (the Amended Plan). Under the Amended Plan, the Board of Directors may grant non-qualified stock options at prices determined by the Board, not to be less than 85% of the fair market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under the Amended Plan may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of the Company s stock. The Amended Plan also allows for awards of stock appreciation rights, restricted and unrestricted stock and restricted stock units.

The Company also has a Non-Qualified Stock Option Plan, under which the Board of Directors may grant non-qualified stock options at prices determined by the Board. These stock options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally over four years.

Restricted Stock Awards

In August 2007, the Company began issuing restricted stock awards to its Board of Directors. These awards are subject to forfeiture until the twelve-month anniversary of the grant date. In December 2007, the Company began issuing restricted stock units to employees. These awards are subject to forfeiture for a period of four years. In January 2008, the Company issued restricted stock awards to its officers. These awards are subject to forfeiture for a period of 23 months.

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Stock-Based Compensation

The Company records compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107 (SFAS No. 123R). The Company records expense over the vesting period using the straight-line method. The calculation of compensation expense for awards under SFAS No. 123R includes the impact of an estimate for forfeitures.

Stock-based compensation expense is recorded in the statements of income in the same line items as cash compensation for the Company s employees as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Cost of revenue service	$ 94	$ 100	$ 321	$ 208
Selling, general and administrative	250	234	717	524
Research and development	14	23	59	56
Total stock-compensation expense	$ 358	$ 357	$ 1,097	$ 788

Stock-based compensation expense under SFAS No. 123R reduced net income by $358,000 and diluted earnings per share by $0.04 for the three months ended September 30, 2008 and reduced net income by $1.1 million and diluted earnings per share by $0.11 for the nine months ended September 30, 2008. Stock-based compensation expense under SFAS No. 123R reduced net income by $357,000 and diluted earnings per share by $0.03 for the three months ended September 30, 2007 and reduced net income by $788,000 and diluted earnings per share by $0.08 for the nine months ended September 30, 2007.

At September 30, 2008, compensation expense related to stock options granted under the Company s Stock Option Plan, but not yet recognized, was $552,000, 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 subsequent changes in estimated forfeitures.

At September 30, 2008, compensation expense related to restricted stock awards granted under the Company s Stock Option Plan, but not yet recognized, was $78,000. This cost will be amortized on the straight-line method over a period of approximately six months.

At September 30, 2008, compensation expense related to restricted stock units granted under the Company s Stock Option Plan, but not yet recognized, was $205,000. This cost will be amortized on the straight-line method over a period of approximately 1.5 years.

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Key Assumptions

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Dividend yield	0%	0%	0%	0%
Expected life	4 years	4 years	4 years	4 years
Expected volatility	74%	83%	78%	85%
Risk-free interest rate	2.9%	4.4%	2.8%	4.6%
Estimated forfeitures	21%	29%	22%	32%

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 historical experience and vesting schedules of similar awards.

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.

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Stock Option Activity

The following table summarizes stock option activity under the Company s Stock Option Plan for the nine months ended September 30, 2008:

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	1,886,467	$ 4.36		
Granted at fair value	253,800	4.23		
Exercised	(40,355)	2.59		
Forfeited	(46,023)	2.99		
Expired	(25,693)	12.47		
Outstanding at September 30, 2008	2,028,196	$ 4.31	6.89	$ 1,222,000
Vested and expected to vest at September 30, 2008	1,733,205	$ 4.40	6.63	$ 1,090,000
Exercisable at September 30, 2008	1,382,543	$ 4.51	6.14	$ 962,000

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 September 30, 2008. The Company issues new shares of common stock upon exercise of stock options.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Weighted-average grant-date fair value	$ 2.81	$ 4.69	$ 2.91	$ 3.35
Aggregate intrinsic value of options exercised	$ 8,000	$ 105,000	$ 88,000	$ 732,000

There were 789,089 vested options in-the-money as of September 30, 2008 and 911,706 vested options in-the-money as of September 30, 2007.

Restricted Stock Activity

The following table summarizes restricted stock award activity under the Company s Stock Option Plan for the nine months ended September 30, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2008	21,000	$ 6.32

Awarded	31,500	$	4.74
Released	(10,500)	$	5.95
Forfeited			
Outstanding at September 30, 2008	42,000	$	5.23

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The following table summarizes restricted stock unit activity under the Company s Stock Option Plan for the nine months ended September 30, 2008:

	Number of Shares	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	94,728		
Awarded	22,817		
Released	(16,448)		
Forfeited	(12,513)		
Outstanding at September 30, 2008	88,584	1.48	$ 323,000
Vested and expected to vest at September 30, 2008	58,732	1.27	$ 196,000

The weighted-average grant-date fair value of restricted stock units granted was $5.79 for the nine months ended September 30, 2008.

5. Comprehensive Income (Loss)

Comprehensive income (loss) consists of two components, net income and other comprehensive income (loss). Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders equity under generally accepted accounting principles but are excluded from net income (loss). The Company s other comprehensive income (loss) is comprised of foreign currency translation adjustments from its subsidiaries not using the U.S. dollar as their functional currency and unrealized losses on investments. The components of other comprehensive income (loss) consisted of a foreign currency translation loss of $83,000 and an unrealized loss on investments of $466,000 for the three months ended September 30, 2008 and a foreign currency translation gain of $5,000 for the three months ended September 30, 2007. The components of other comprehensive income (loss) consisted of a foreign currency translation gain of $18,000 and an unrealized loss on investments of $466,000 for the nine months ended September 30, 2008 and a foreign currency translation loss of $8,000 for the nine months ended September 30, 2007.

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; Boston, Massachusetts; Dallas, Texas; Vancouver, Canada; Taipei, Taiwan; and Tokyo, Japan. The Company leases office space in Akron, Ohio on a month-to-month basis.

In February 2004, the Company amended the lease of its former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters. If the Company defaults under its corporate headquarters lease, the landlord has the ability to demand repayment for certain cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was $1.4 million at September 30, 2008, which decreases on the straight-line basis over the length of its ten-year headquarters lease.

Rent expense was $287,000 for the three months ended September 30, 2008 and $256,000 for the three months ended September 30, 2007. Rent expense was $865,000 for the nine months ended September 30, 2008 and $798,000 for the nine months ended June 30, 2007.

As of September 30, 2008, the Company had $900,000 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 classified as restricted cash.

Contractual commitments at September 30, 2008 were as follows (in thousands):

Operating leases:	
Remainder of 2008	$ 334
2009	1,225
2010	1,169
2011	1,036
2012	1,030
Thereafter	1,859
Total commitments	$ 6,653

Legal Proceedings

IPO Litigation

In Summer and early Fall 2001, four purported 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, is now the operative complaint. The operative complaint alleges violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The suit purports 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 allege 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 allege 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 seeks damages in an unspecified amount.

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On December 5, 2006, the Second Circuit 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.

On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The amended complaints include a number of changes, such as changes to the definition of the purported class of investors, and the elimination of the individual defendants as defendants. On September 27, 2007, the plaintiffs moved to certify a class in the six focus cases. On November 14, 2007, the issuers and the underwriters named as defendants in the six focus cases filed motions to dismiss the amended complaints. On March 26, 2008, the district court dismissed the Securities Act claims of those members of the putative classes in the focus cases who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. With respect to all other claims, the motions to dismiss were denied. On October 10, 2008, at the request of Plaintiffs, Plaintiffs motion for class certification was withdrawn, without prejudice. Due to the inherent uncertainties of

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litigation, the Company cannot accurately predict the ultimate outcome of this matter. If the Company is found liable, the Company is unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company s insurance coverage, and whether such damages would have a material impact on the Company s results of operations or financial condition in any future period.

7. Segment Information

The Company follows the requirements of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related 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 September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Total revenue:				
North America	$ 14,784	$ 12,445	$ 44,485	$ 40,897
Asia	1,256	1,155	3,691	2,868
Other foreign	162	4	510	29
Total revenue (1)	$ 16,202	$ 13,604	$ 48,686	$ 43,794

	September 30, 2008	December 31, 2007
Long-lived assets:		
North America	$ 1,043	$ 1,017
Asia	162	37
Total long-lived assets	$ 1,205	$ 1,054

(1) Revenue is attributed to geographies based on the location of the customer invoiced.

Significant Customers

Ford Motor Company (Ford) accounted for $2.6 million, or 16.2%, of total revenue for the three months ended September 30, 2008. No other customers accounted for 10% or more of total revenue for the three or nine months ended September 30, 2008. No customers accounted for 10% or more of total revenue for the three or nine months ended September 30, 2007.

Ford had an accounts receivable balance of approximately $2.3 million, or 22% of total accounts receivable, as of September 30, 2008. As of November 3, 2008, the Company had collected all $2.3 million of the September 30, 2008 balance from Ford. Microsoft Corporation (Microsoft) had an accounts receivable balance of approximately $1.1 million, or 11% of total accounts receivable as of September 30, 2008. Approximately $288,000 of this balance was past due as of September 30, 2008 and the remaining balance was current. As of November 3, 2008, the Company had collected $320,000 of the September 30, 2008 balance from Microsoft. No other customers accounted for 10% or more of total accounts receivable as of September 30, 2008.

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

From time to time, information provided by us, statements made by our employees or information included in our filings with the Securities and Exchange Commission (SEC) may contain statements that are forward-looking statements involving risks and uncertainties. In particular, statements in Management s Discussion and Analysis of Financial Condition and Results of Operations relating to our revenue, profitability, growth initiatives and sufficiency of capital may be forward-looking statements. The words expect, anticipate, plan, believe, seek, estimate and expressions are intended to identify such forward-looking statements. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that could cause our future results to differ materially from those expressed in any forward-looking statements made by, or on behalf of, us. Many such factors are beyond our ability to control or predict. Readers are accordingly cautioned not to place undue reliance on forward-looking statements. We disclaim any intent or obligation to update any forward-looking statements, whether in response to new information or future events or otherwise. Important factors that may cause our actual results to differ from such forward-looking statements include, but are not limited to, the factors discussed in Item 1A of Part II of this quarterly report, our quarterly report for the quarterly periods ended March 31, 2008 and June 30, 2008 and in Part I of our annual report on Form 10-K for the year ended December 31, 2007 entitled Risk Factors.

Overview

We provide software and engineering services to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) 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, PDAs, handheld data collection devices, personal media players and smartphones. We primarily focus the sale of our software and engineering services to customers developing smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile . However, with acquisition of customers and rights to license Adobe Flash Lite technology from NEC Corporation of America, we expect to support customers who are using Adobe Flash Lite technology in other operating systems such as 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 (OEMs), original design manufacturers (ODMs), silicon vendors (SVs), peripheral vendors, and enterprises with customized device needs such as retailers and wireless operators that market and distribute connected smart devices. The software and engineering services we provide our customers are delivered, utilized and deployed throughout various phases of our customers device life cycle, including design, development, customization, quality assurance and deployment.

Critical Accounting Judgments

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company s critical accounting policies as those that are most important to the portrayal of its financial condition and results of operations, and those that require a company to make its 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 1 of Part I, Financial Statements Note 1 Summary of Significant Accounting Policies. 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.

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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, time records and customer acceptance, as and when applicable, are 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.

We recognize software revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. Service revenue from time and materials contracts and training services is recognized as services are performed. For certain fixed-price professional engineering service contracts that require significant production, modification, or customization of software, we account for these arrangements using the percentage-of-completion method under Statement Of Position (SOP) 81-1, as contemplated by paragraph 7 of SOP 97-2. We use the percentage-of-completion method of accounting specified within SOP 81-1, as contrasted to alternative approaches outlined in SOP 81-1, because it is the most preferable 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 in our case and it better matches revenue recognized with the costs incurred in our instance. 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. We rely on estimates of total expected hours as a measure of performance in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period 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, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. 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. Accordingly, the judgments involved in assessing VSOE have an impact on 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, provided that such element meets the criteria for treatment as a separate unit of accounting. In the absence of fair value for a delivered element, we allocate revenue first to the fair value of the undelivered elements and allocate the residual revenue to the delivered elements. In the absence of fair value for an undelivered element, the arrangement is accounted for as a single unit of accounting, resulting in a delay of revenue recognition for the delivered elements until the undelivered elements are fulfilled. As a result, contract interpretations and assessments of fair value are sometimes required to determine the appropriate accounting.

When elements such as 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, some of which may be guaranteed. We recognize royalty revenue when we receive the royalty report from the customer or when such royalties are contractually guaranteed and the revenue recognition criteria are met, particularly that collectability is reasonably assured.

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Deferred revenue includes deposits received from customers for service contracts, customer advances under OEM licensing agreements and unamortized maintenance and support contract revenue.

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. We consider many factors when making this estimate, including analyzing accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history, when evaluating the adequacy of the allowance for doubtful accounts. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimated reserve.

Investments

We account for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). We adopted SFAS No. 157, Fair Value Measurements (SFAS No. 157) as of January 1, 2008 to measure the fair value of certain of our financial assets required to be measured on a recurring basis, including available-for-sale securities. Under SFAS No. 157, based on the observability of the inputs used in the valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value are classified and disclosed in one of the following three categories:

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.

We adopted FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP 157-3), which was issued in October 2008 and became effective immediately for any unissued financial statements. FSP clarifies the application of SFAS No. 157 to financial assets for which an active market does not exist. Specifically, FSP 157-3 addresses the following SFAS No. 157 application issues:

a. How the reporting entity s own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist.

b. How available observable inputs in a market that is not active should be considered when measuring fair value.

c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

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FSP 157-3 applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurement in accordance with SFAS No. 157. We obtained an independent valuation of our ARS as of September 30, 2008 and have determined the fair value to be $6,059,000 as compared to par value of $6,525,000. As a result, we recorded an unrealized loss on our ARS of $466,000 for the three months ended September 30, 2008. Although we are uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be only temporary. In addition, we have the intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in market value. Therefore, this unrealized loss is not included in earnings, but is reflected in other comprehensive income within shareholders equity. It is possible that additional declines in fair value may occur in the future. If general economic conditions worsen or specific factors used in determining fair value deteriorate, we may further adjust the carrying value of these investments.

Stock-Based Compensation

We record compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. We record expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS No. 123R includes an estimate for forfeitures.

At September 30, 2008, total compensation cost related to stock options granted under our Stock Option Plan but not yet recognized was $552,000, 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 subsequent changes in estimated forfeitures.

At September 30, 2008, total compensation cost related to restricted stock awards granted under our Stock Option Plan but not yet recognized was $78,000. This cost will be amortized on the straight-line method over a period of approximately six months.

At September 30, 2008, total compensation cost related to restricted stock units granted under our Stock Option Plan but not yet recognized was $205,000. This cost will be amortized on the straight-line method over a period of approximately 1.5 years.

Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the countries in which we operate. This process involves estimating our current tax exposure together with assessing temporary differences resulting from 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 in the statements of operations. 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 would be realized, the valuation allowance would be reversed. In order to realize our deferred tax assets, we must be able to generate sufficient taxable income.

Because we do business in foreign tax jurisdictions, our sales may be subject to other taxes, particularly withholding and earnings distribution taxes. The tax regulations governing these other taxes are complex, causing us to have to make assumptions about the appropriate tax treatment and estimates of such taxes.

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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 future results.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
Revenue:				
Software	54%	66%	60%	65%
Service	46	34	40	35
Total revenue	100	100	100	100
Cost of revenue:				
Software	42	49	47	49
Service	31	25	27	26
Total cost of revenue	73	74	74	75
Gross profit	27	26	26	25
Operating expenses:				
Selling, general and administrative	18	19	18	19
Research and development	4	4	4	4
Total operating expenses	22	23	22	23
Gain on sale of patents	2		1	
Income from operations	7	3	5	2
Interest and other income		1		2
Income before income taxes	7	4	5	4
Income tax expense		(1)		
Net income	7%	3%	5%	4%

Revenue

Total revenue consists of sales of software and engineering services to smart device makers. Software revenue consists of sales of third-party software and sales of our own proprietary software products which include software licenses, software development kits and smart device reference designs as well as royalties from our software products and royalties from certain engineering service contracts. Engineering service revenue is derived from hardware and software development activities, support contracts, fees for customer training, and rebillable expenses.

Total revenue was $16.2 million for the three months ended September 30, 2008 and $13.6 million for the three months ended September 30, 2007, representing an increase of $2.6 million, or 19%. This increase was driven by engineering service revenue, partially offset by lower software sales. Total revenue was $48.7 million for the nine months ended September 30, 2008 and $43.8 million for the nine months ended September 30, 2007, representing an increase of $4.9 million, or 11%. This increase was due to an increase in both software and engineering service revenue.

Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and engineering services billed to foreign customers from our operations located in North America. We currently have operations outside North America in Taipei, Taiwan and Tokyo, Japan. Revenue from customers located outside of North America was $1.4 million for the three months ended September 30, 2008 and $1.2 million for the three months ended September 30, 2007, representing an increase of $200,000, or 17%. This increase was primarily due to a 227% increase in Asia Pacific service revenue. Revenue from customers located outside of North America was $4.2 million for the nine months ended September 30, 2008 and $2.9 million for the nine months ended September 30, 2007, representing an increase of $1.3 million, or 45%. This increase was primarily due to a 202% increase in Asia Pacific service revenue.

Software revenue

Software revenue for the three and nine months ended September 30, 2008 and 2007 is presented below (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
	(unaudited)		**(unaudited)**	
Software revenue:				
Third-party software	$ 7,885	$ 8,065	$ 27,022	$ 25,438
Proprietary software	831	886	2,370	2,890
Total software revenue	$ 8,716	$ 8,951	$ 29,392	$ 28,328
Software revenue as a percentage of total revenue	54%	66%	60%	65%
Third-party software revenue as a percentage of total software revenue	90%	90%	92%	90%

The vast majority of our third-party software revenue is comprised of the resale of Microsoft Embedded operating systems. The biggest portion of our proprietary software revenue is attributable to royalty revenue from service contracts.

Third-party software revenue was $7.9 million for the three months ended September 30, 2008 and $8.1 million for the three months ended September 30, 2007, representing a decrease of $200,000, or 2%. We generated $277,000 in Flash Lite licensing revenue for the three months ended September 30, 2008 compared to none for the three months ended September 30, 2007. We generated $23,000 in Solidcore S3 Control licensing revenue for the three months ended September 30, 2008 compared to none for the three months ended September 30, 2007.

Third-party software revenue was $27.0 million for the nine months ended September 30, 2008 and $25.4 million for the nine months ended September 30, 2007, representing an increase of $1.6 million, or 6%. This increase was due primarily to $1.4 million in Flash Lite software licensing revenue and Solidcore S3 Control licensing revenue that were not present in the same period in 2007.

Proprietary software revenue was $831,000 for the three months ended September 30, 2008 and $886,000 for the three months ended September 30, 2007, representing a decrease of $55,000, or 6%. Proprietary software revenue was $2.4 million for the nine months ended September 30, 2008 and $2.9 million for the nine months ended September 30, 2007, representing a decrease of $500,000, or 17%. These decreases were due primarily to lower SDIO revenue and lower service contract royalties as certain guaranteed minimum royalties expired. Royalty revenue from service contracts was $172,000 for the three months ended September 30, 2008 and $420,000 for the three months ended September 30, 2007. Service contract royalty revenue was $847,000 for the nine months ended September 30, 2008 and $1.2 million for the nine months ended September 30, 2007.

Service revenue

Service revenue was $7.5 million for the three months ended September 30, 2008 and $4.7 million for the three months ended September 30, 2007, representing an increase of $2.8, or 60%. Service revenue represented 46% of total revenue for the three months ended September 30, 2008 and 34% of total revenue for the three months ended September 30, 2007. This increase was primarily due to services provided to Ford Motor Company (Ford) under a new project, which began in May 2008. Revenue under this arrangement was $2.6 million for the three months ended September 30, 2008 compared to none in the prior year. Billable hours increased by 68% for the three months ended September 30, 2008, compared to the prior year, driven by higher activity levels in both the North

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American and Asia Pacific regions. Service revenue in the Asia Pacific region increased 227% and represented 11% of service revenue for the three months ended September 30, 2008, compared to 6% for the three months ended September 30, 2007.

Service revenue was $19.3 million for the nine months ended September 30, 2008 and $15.5 million for the nine months ended September 30, 2007, representing an increase of $3.8 million, or 25%. Service revenue represented 40% of total revenue for the nine months ended September 30, 2008 and 35% of total revenue for the nine months ended September 30, 2007. Growth in core engineering services revenue in both North America and Asia Pacific drove the increase for the reasons mentioned above, partially offset by a decrease in rebillable revenue of $736,000. Billable hours increased by 33% for the nine months ended September 30, 2008 compared to the prior year, driven by higher activity levels in both the North American and Asia Pacific regions. Service revenue in the Asia Pacific region increased 202% and represented 11% of service revenue for the nine months ended September 30, 2008 compared to 4% for the nine months ended September 30, 2007.

Gross profit and gross margin

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software products, the costs of components for our hardware reference designs, product media, product duplication and manuals. Amortization of intangible assets, acquired from Vibren Technologies Inc. in June 2005 and from NEC of America in December 2007, is also included in cost of software revenue and was $22,000 for the three months ended September 30, 2008 and zero for the three months ended September 30, 2007. Amortization of intangible assets included in cost of software revenue was $66,000 for the nine months ended September 30, 2008 and $96,000 for the nine months ended September 30, 2007. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, related facilities and depreciation costs. Gross profit on the sales of third-party software products is also positively affected by rebates and volume discounts we receive from Microsoft which we earn through the achievement of defined objectives.

Rebates comprised $76,000 of our third-party software gross profit for the three months ended September 30, 2008 and $190,000 of our gross profit for the three months ended September 30, 2007. Rebates comprised $227,000 of our third-party software gross profit for the nine months ended September 30, 2008 and $539,000 of our gross profit for the nine months ended September 30, 2007. These decreases were the result of changes to the rebate program which Microsoft makes periodically. Microsoft has frequently modified its rebate program, and future modifications could have the effect of reducing, or even eliminating, the rebate credit.

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

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
	(unaudited)		**(unaudited)**	
Software gross profit	$1,969	$2,259	$ 6,573	$ 6,877
As a percentage of total software revenue	23%	25%	22%	24%
Service gross profit	$2,464	$1,224	$ 6,286	$ 4,110
As a percentage of service revenue	33%	26%	33%	27%
Total gross profit	$4,433	$3,483	$12,859	$10,987
As a percentage of total revenue	27%	26%	26%	25%

Software gross profit and gross margin

Software gross profit was $2.0 million for the three months ended September 30, 2008 and $2.3 million for the three months ended September 30, 2007, representing a decrease of $300,000, or 13%. Software gross profit as a percentage of software revenue was 23% for the three months ended September 30, 2008 and 25% for the three months ended September 30, 2007. The decrease in gross profit was due primarily to lower sales of Microsoft embedded operating systems, coupled with a decline in related gross margin, and lower sales of high-margin proprietary software.

Software gross profit was $6.6 million for the nine months ended September 30, 2008 and $6.9 million for the nine months ended September 30, 2007, representing a decrease of $300,000, or 4%. Software gross profit as a percentage of software revenue was 22% for the nine months ended September 30, 2008 and 24% for the nine months ended September 30, 2007.

Our proprietary software sales have traditionally generated high gross margins, which were 97% this quarter, while third-party software sales typically generate much lower gross margin. Third-party software margin was 15% for the three months ended September 30, 2008, compared to 17% for the same period in the prior year. The decline in third-party software gross margin was due to lower sales to middle-tier customers that typically have higher margin than larger customers, partially offset by higher margins resulting from sales of Flash Lite and Solidcore S3 Control.

Service gross profit and gross margin

Service gross profit was $2.5 million for the three months ended September 30, 2008 and $1.2 million for the three months ended September 30, 2007, representing an increase of $1.3 million, or 108%. Service gross profit as a percentage of service revenue was 33% for the three months ended September 30, 2008 and 26% for the three months ended September 30, 2007. Service gross profit was $6.3 million for the nine months ended September 30, 2008 and $4.1 million for the nine months ended September 30, 2007, representing an increase of $2.2 million, or 54%. Service gross profit as a percentage of service revenue was 33% for the nine months ended September 30, 2008 and 27% for the nine months ended September 30, 2007. The overall improvement in service gross profit and gross margin is due to a significant increase in service revenue which has had a positive effect on utilization and created efficiencies achieved through achieving significantly higher service revenue without a corresponding increase in certain fixed costs. Our facilities and depreciation costs, a portion of which is included in service cost of revenue, are relatively fixed and are being spread over a larger revenue base, which has the effect of increasing service gross profit as service revenue increases.

Operating expenses

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and benefits for our sales, marketing and administrative personnel and related facilities and depreciation costs as well as professional services fees (e.g., consulting, legal and audit).

Selling, general and administrative expenses were $3.0 million for the three months ended September 30, 2008 and $2.6 million for the three months ended September 30, 2007, representing an increase of $400,000, or 15%. Selling, general and administrative expenses represented 18% of total revenue for the three months ended September 30, 2008 and 19% of total revenue for the three months ended September 30, 2007. Selling, general and administrative expenses were $9.0 million for the nine months ended September 30, 2008 and $8.2 million for the nine months ended September 30, 2007, representing an increase of $800,000, or 10%. Selling, general and administrative expenses represented 18% of total revenue for the nine months ended September 30, 2008 and 19% of total revenue for the nine months ended September 30, 2007. The increases noted above were due primarily to

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higher sales expenses in both North America and the Asia Pacific region. We incurred costs in Japan for the three and nine months ended September 30, 2008 for sales and business development activities in Japan as a result of reestablishing a direct sales presence in Japan during the fourth quarter of 2007.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, contractor and consultant costs, component costs and related facilities and depreciation costs.

Research and development expenses were $622,000 for the three months ended September 30, 2008 and $573,000 for the three months ended September 30, 2007, representing an increase of $49,000, or 9%. Research and development expenses were $1.8 million for the nine months ended September 30, 2008 and $1.7 million for the nine months ended September 30, 2007, representing an increase of $100,000, or 6%. Research and development expenses represented 4% of total revenue for all periods presented. We continue to execute and evolve our product strategy and invest in new product development initiatives; however, the timing and magnitude of our investments are difficult to predict.

Gain on sale of patents

We realized a gain of $300,000 on the sale of patents for the three and nine months ended September 30, 2008 compared to none in the year-ago periods.

Interest and other income

Interest and other income consists of interest earnings on our cash, cash equivalents and investments. Interest and other income was $58,000 for the three months ended September 30, 2008 and $152,000 for the three months ended September 30, 2007, representing a decrease of $94,000, or 62%. This decrease was due to lower interest income as a result of lower interest rates.

Interest and other income was $306,000 for the nine months ended September 30, 2008 and $719,000 for the nine months ended September 30, 2007, representing a decrease of $413,000, or 57%. This decrease was due to a realized gain on the sale of marketable securities of $287,000, which benefited the nine months ended September 30, 2007, coupled with lower interest rates as compared to the prior year.

Income Tax Expense

Income tax expense was $16,000 for the three months ended September 30, 2008 and $89,000 for the three months ended September 30, 2007, representing a decrease of $73,000, or 82%. Income tax expense was $143,000 for the nine months ended September 30, 2008 and $237,000 for the nine months ended September 30, 2007, representing a decrease of $94,000, or 40%. This expense primarily related to corporate income taxes, primarily from our Taiwan branch.

Liquidity and Capital Resources

As of September 30, 2008, we had $16.1 million of cash, cash equivalents and investments compared to $15.0 million at December 31, 2007. These totals include $900,000 of restricted cash at September 30, 2008 and $1,050,000 at December 31, 2007. This restricted cash secures our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. Our working capital at September 30, 2008 was $12.5 million compared to $14.7 million at December 31, 2007. The decrease in working capital was primarily due to the reclassification of our the majority of our auction rate securities, or ARS, on our balance sheet from short-term investments at December 31, 2007 to long-term investments at September 30, 2008.

Our $6.1 million of investments consist of auction rate securities, or ARS. ARS are securities whose interest or dividend rate is reset periodically through a Dutch Auction process, usually every 7, 28 or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are 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 holder to sell their position at a reset date. During February 2008, the ARS auction process began to fail broadly throughout the market (i.e. there were more sellers than bidders and since the interest or dividend rate could not be reset through a normally functioning Dutch Auction process, the auctions failed.) These investments, other than those classified as current, are illiquid and we are unable to determine with any certainty when these investments will become liquid. Liquidity of these investments is contingent on the redemption of the investments by issuers, settlement by the underwriters as further described below or sales of the securities in a secondary market. Failed ARS that we held with a par value of $2,250,000 were redeemed by their issuers at par during the nine months ended September 30, 2008. This redeemed amount represents 26% of the Company s ARS portfolio balance immediately following the ARS market failure in February 2008. The New York Attorney General has recently announced settlements with large investment banks whereby the underwriters of ARS will repurchase certain illiquid ARS from its current customers. We are not a current customer of any of the investment banks that have agreed to settlements and are therefore uncertain whether any of its ARS will be repurchased. ARS are currently being sold on the secondary market at discounts that range from 8% to 30% depending on the type of security. Our ARS have AAA ratings and continue to pay interest according to the stated terms.

During the nine months ended September 30, 2008, operating activities provided cash of $2.0 million attributable to our net income of $2.5 million and non-cash expenses of $1.5 million, offset by certain working capital items. During the nine months ended September 30, 2007, operating activities provided cash of $2.1 million attributable to our net incom