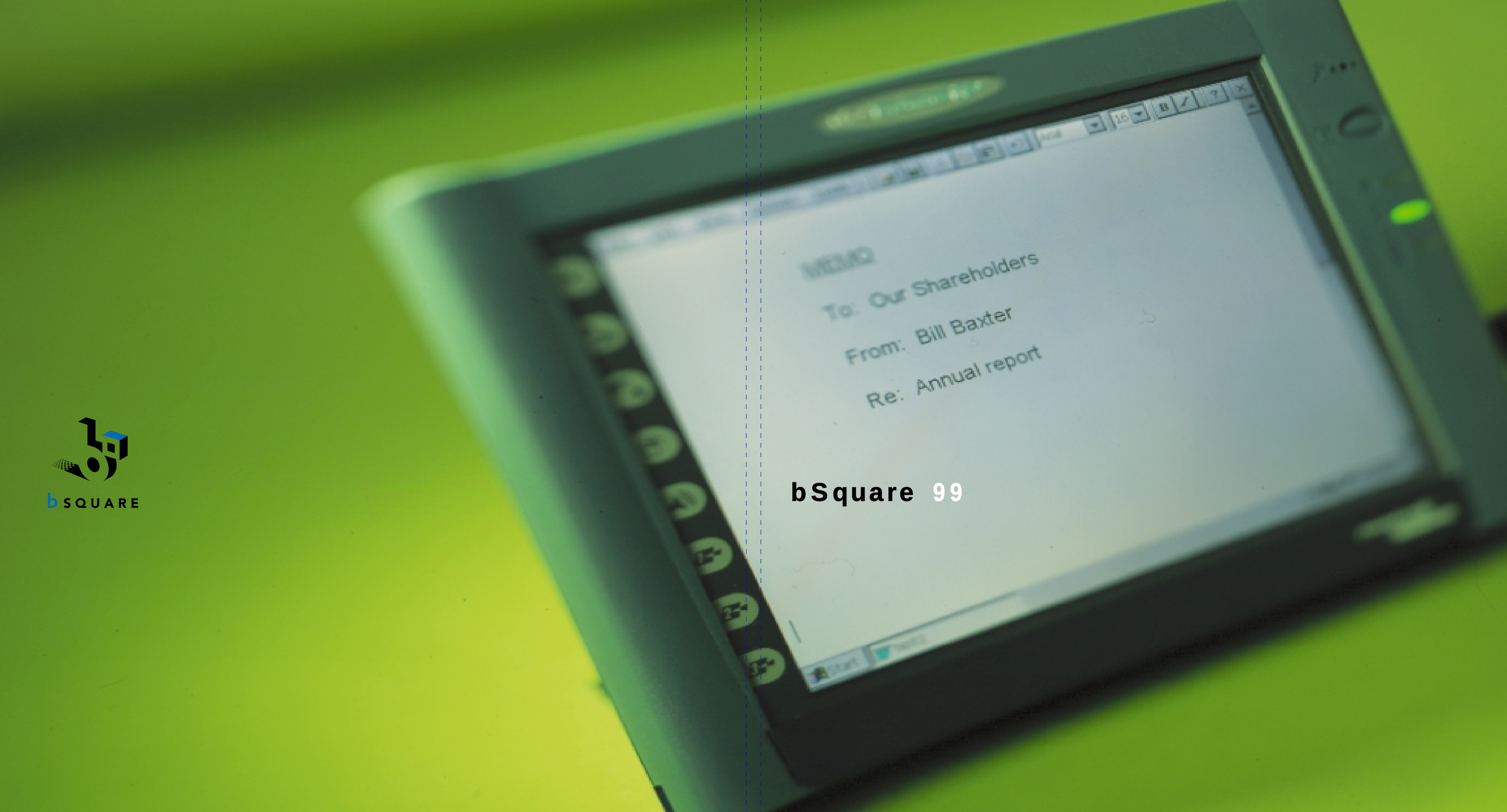


bSquare 99

> > You see them everywhere: at work, at home, in cars and factories. Intelligent Computing Devices (ICDs) are changing the way we live and work, giving people and businesses access to information anytime, anywhere. bSquare provides a broad range of software products and services that integrate Microsoft Windows operating systems and other technologies into ICDs, making them more functional.

b

> > **bSquare solutions enable the ICD revolution. bSquare is the first to specialize in the Windows CE operating system, specifically designed for powerful, portable computing. Our engineering depth, range of tools and sophistication for ICD development make bSquare second to none.**

> > And we're one of the first to provide thin client development solutions using the Windows NT Embedded operating system.

> > Our commitment to research and development helps protect and extend our leadership and growth. We have one of the most comprehensive sets of software solutions and tools to power the ICD explosion.

> > bSquare is a primary mover in this new and rapidly growing market. Everything we do is designed to help our customers, and our customers are the companies shaping the ICD revolution.

first

> > In shaping the function, performance and capabilities of ICDs, we work with the leaders like IBM; Data General; Hewlett-Packard; Sharp; NEC; Casio; and others.

> > **Our relationships extend throughout the industry and connect bSquare to semiconductor manufacturers, OEMs, and software providers.**

> > bSquare partners with software leaders to deliver industry-leading software bundled with our own products and services, ultimately providing a comprehensive, one-stop shop for our customers.

> > bSquare co-markets with industry leaders, creating greater promotional power through traditional and online marketing, and attracting new business leads from every corner of our industry.

> > bSquare technology is helping to build a connected world.

connected

b inside

> > bSquare solutions are inside new interactive TV technology for consumers, bringing information and entertainment to people whenever and wherever they want it.

> > **bSquare solutions are inside new technology for health care professionals, keeping them connected to their patients, staff and records.**

> > bSquare software and technology are inside new products for manufacturers, taking process control technology right to the factory floor.

> > bSquare solutions are inside new technology for your car, powering connectivity and communication.

> > bSquare solutions are inside...

> > Our business is about speed. As product lifecycles continue to shrink, the importance of reducing product time to market grows. Faster to market can mean extended market life and a greater return on investment for our customers.

> > bSquare has more than 300 top software engineers with extensive experience and an unparalleled understanding of what the market wants and needs, enabling bSquare to help customers get high quality products to market quickly.

> > **While each solution we develop for our customers is unique, we continue to drive down development cycles and time to market. As our knowledge database grows, we get even faster.**

> > bSquare CE Xpress Kits™ and CE Interface Composer speed up the process for developers; our CEValidator™ makes troubleshooting simpler and validation more reliable.

> > When products deploying bSquare software are ready for market, they are ready for work. Our focus is on quality assurance, which is another way of enabling OEMs to get to market faster.

fast

b

> > In some shape or form, bSquare solutions are in every ICD that operates on Windows CE. Those ICDs are transforming the way people and businesses acquire and share information, adding value and bringing convenience, efficiency and insights to consumers and business. bSquare solutions bring it all together.

> > With bSquare solutions ICD manufacturers can choose from a rapidly expanding number of semiconductors to suit their specific needs.

> > bSquare's broad line of products and services frees OEMs to focus on their specific strengths: hardware design, functionality, user interface or any feature that will give their product an edge in the marketplace.

> > **You're free to enjoy a broader selection of television and music programming: bSquare software drives the form and function of set top boxes – expanding the viewing experience. You're free to discover new opportunities as bSquare helps make life a little better at home, in the office and on the road.**

progressive

Dear bSquare Shareholders,

Our company realized many significant achievements in 1999, ranging from design wins in key market segments to our successful IPO to consistent recognition as a leading solution provider. bSquare is one of the first movers in providing software products and services for the Intelligent Computing Device market. Our market is broadly defined by four segments: set-top boxes, mobile and wireless, thin clients, and general embedded. And we achieved considerable progress in each segment. bSquare solutions include software products and services that help our customers develop the feature-rich products that are changing the way we work, live and play. If you need an example of what bSquare does, just pick up any product that runs on the Microsoft Windows CE operating system: the software features and functions you'll be using are the work of bSquare.

One of our biggest successes in 1999 was going public. Our completed IPO was the culmination of a lot of hard work – the ultimate team effort. We feel now as we did then, that our IPO is a tool to help empower bSquare to reach new levels of success in the future, to capitalize on our new public status by expanding on our business platform to help drive shareholder value.

We have become an industry leader by adhering to the fundamental values permeating our culture. We believe that one of our single, most important values is respect. Respect for our customers and our partners, and between our own employees. By expanding on that fundamental premise, bSquare has established a solid reputation for delivering highly innovative software solutions on time and on budget. Our customers have come to associate the name bSquare with innovative, high-quality solutions for ICDs: a defining attribute of our brand. And we reinforce this focus throughout our organization by always putting the customer first. Because of this, we firmly believe bSquare will be an industry leader well into the future.

William T. Baxter
Chairman of the Board,
President and
Chief Executive Officer

>>> **LEADING EDGE TALENT**

300+ engineers

> bSquare has more than 300 top software engineers engaged in research and development and professional services with extensive experience and an unparalleled understanding of what the market wants and needs, enabling bSquare to help customers get high quality products to market quickly.

Just one example is our work in thin client solutions. Thin client devices include Windows-based terminals and web-based terminals. bSquare was able to capture the vast majority of Windows-based terminal design wins in 1999. According to International Data Corporation research, Windows-based terminals account for nearly 60% of the network computer market, creating a great foundation for deploying new, highly innovative thin client computing devices. To further propel this market, Windows 2000 now ships with native Windows-based terminal support, making it easier for information technology departments to deploy Windows-based terminals within an enterprise. And thin clients are only one of several opportunities for bSquare. We also focus on advanced digital set-top boxes, mobile and wireless computing devices, and Internet-enabled appliances. And bSquare is positioning itself to continue to succeed. Just this year we were recognized as the twelfth fastest growing high technology company in the U.S. by Deloitte & Touche, and our popular bFax Pro® 4.0 was recognized by the United States largest software industry advocacy organization, the Washington Software Alliance, as the Business Product of the Year.

Despite all our accomplishments in 1999, we do not intend to rest. The pace of innovation in the computing industry is astonishing. In the coming year bSquare will strive to expand its business in order to capitalize on the growth of all of Microsoft s Windows Powered solutions. We are firmly committed to helping OEMs proliferate intelligent computing devices that leverage the inherent advantages of the Microsoft operating systems. In the face of this opportunity, bSquare will continuously seek to identify, understand, and adapt to changes within the industry to strengthen our company, to deliver pertinent solutions to our customers and to drive outstanding shareholder value.

The world is entering the age of intelligent computing devices. Many of the infrastructure components are now in place to enable the rapid proliferation of ICDs. We believe that the adoption of a wide array of non-PC computing devices will continue to increase. Because of our focus on servicing this market, we believe bSquare will emerge as a significant industry leader in helping to enable the age of ICDs.

From all of us at bSquare, I wish to thank each of you for investing in our vision. bSquare is focused on making this a mutually fulfilling relationship.

WILLIAM T. BAXTER
Chairman of the Board, President and Chief Executive Officer

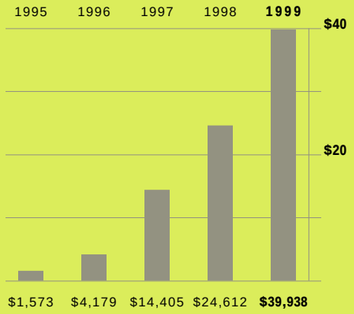
>>> **HOW BIG IS OUR OPPORTUNITY?**

14 million units

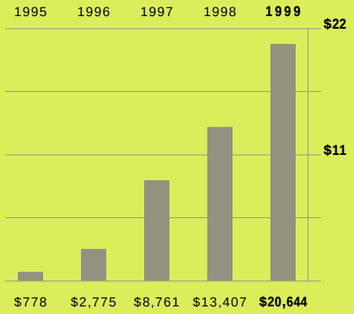
* "Windows CE and the Future of Embedded Systems Development", a December 1998 report from Venture Development Corporation, estimates that the number of ICDs utilizing Windows CE will increase from 1 million units in 1999 to more than 14 million units by 2003.

Financial Charts

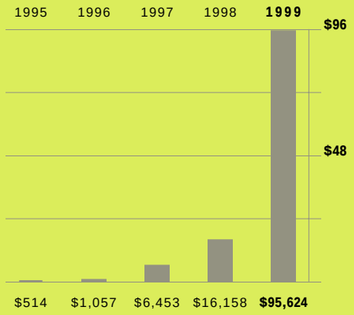
Revenue



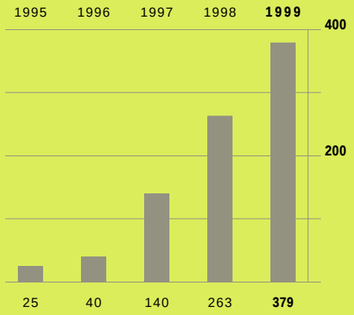
Gross Profit



Total Assets



Number of Employees (numbers as stated)



Selected Financial Data

Year Ended December 31,	(unaudited) 1995	1996	1997	1998	**1999**
Consolidated Statement of Operations Data					
Revenue	$1,573	$4,179	$14,405	$24,612	**$39,938**
Gross profit	778	2,775	8,761	13,407	**20,644**
Income from operations	692	1,964	4,564	3,170	**1,881**
Net income	$ 693	$1,971	$ 3,806	$ 2,300	**$ 1,691**
Basic earnings per share	$ 0.03	$ 0.09	$ 0.18	$ 0.12	**$ 0.06**
Shares used in computation of basic earnings per share	21,000	22,106	21,400	18,372	**27,858**
Diluted earnings per share	$ 0.03	$ 0.09	$ 0.17	$ 0.08	**$ 0.06**
Shares used in computation of diluted earnings per share	21,000	22,106	21,781	27,475	**30,539**
Consolidated Balance Sheet Data					
Cash, cash equivalents and short-term investments	$ 103	$ 187	$ 2,286	$ 6,906	**$82,397**
Working capital	236	658	2,918	10,280	**81,178**
Total assets	514	1,057	6,453	16,158	**95,624**
Long-term obligations, net of current portion	–	–	1,743	289	**–**
Mandatorily redeemable convertible preferred stock	–	–	–	14,417	**–**
Shareholders' equity (deficit)	261	924	2,330	(1,298)	**88,538**

Management's Discussion and Analysis of Results of Operations and Financial Condition

Forward-looking Statements

This Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 based on current expectations, estimates and projections about our industry and our management's beliefs and assumptions. When used in this Annual Report and elsewhere, the words "believes," "plans," "estimates," "intends," "anticipates," "seeks" and "expects" and similar expressions are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. Accordingly, actual results may differ materially from those anticipated or expressed in such statements. Particular attention should be paid to the risk factors described in our Annual Report on Form 10-K and other reports or documents that we file from time to time with the Securities and Exchange Commission involving potential fluctuations in our quarterly operating results, our reliance on Microsoft, uncertainty about the Windows CE market, unpredictability of future revenue, the intensely competitive nature of our industry, our limited operating history, management of growth, the integration of any future acquisitions and our reliance on third parties, manufacturers, distributors and suppliers. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

The following Management's Discussion and Analysis of Results of Operations and Financial Condition should be read in conjunction with our consolidated financial statements and related notes.

Overview

We are a leading provider of software solutions that enable the development and proliferation of a wide variety of intelligent computing devices based on the Microsoft Windows-based operating systems. Intelligent computing devices, or ICDs, are a class of non-personal computer devices that offer electronic connectivity. We work with semiconductor vendors and original equipment manufacturers to provide software products and engineering services for the development of intelligent computing devices.

We enable the rapid and low-cost deployment of intelligent computing devices by providing a variety of software products and services for the development, integration and deployment of Windows-powered operating systems with industry-specific applications. We also develop software applications that are licensed to end users to provide intelligent computing devices with additional functionality. Our products and services are marketed and supported on a worldwide basis through a direct sales force augmented by distributors.

Our revenue totaled $14.4 million in 1997, $24.6 million in 1998 and $39.9 million in 1999. We generated net income of $3.8 million in 1997, $2.3 million in 1998 and $1.7 million in 1999.

To date, we have derived substantially all of our revenue from the provision of services to Microsoft, semiconductor vendors and original equipment manufacturers. We also generate product revenue from software sales and royalty licenses. We perform our services under both time-and-materials contracts and fixed-fee contracts. We also receive a small portion of service revenue from the provision of contract support services upon the purchase of our software products. We sell our packaged software products through standard retail channels, our direct sales force and through indirect channels, such as resellers. In addition, we receive royalty payments from original equipment manufacturers related to the bundling of our software on their intelligent computing devices and, more recently, from the license to them of software products contained in our intelligent computing device integration tool kits.

Microsoft Master Development and License Agreement

In 1997, 1998 and 1999, approximately 39%, 79% and 88% of our revenue, respectively, was generated under our master development and license agreement with Microsoft. The master agreement, the current renewable term of which concludes in July 2000, includes a number of project-specific work plans. We bill Microsoft on a time-and-materials basis, although each project has a maximum dollar cap, and recognize revenue generated under the master agreement as the services are rendered. The master agreement and each of the individual work plans may be modified or terminated by Microsoft at any time. The average budget of our current work plans under the master agreement is approximately $1,650,000. While we anticipate that our relationship with Microsoft will remain strong, we are unable to predict the magnitude and number of future projects for Microsoft.

In addition, under a non-competition provision contained in the master agreement, we must obtain written permission from Microsoft in order to design or develop products, or provide services in connection with products, which compete with Windows, or related products in existence as of October 1, 1998 or which Microsoft is developing or intends to develop or acquire. In January 2000, Microsoft eliminated this non-competition provision in conjunction with the execution of a new Porting Partners agreement.

Historical Results of Operations

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

Consolidated Statement of Operations Data

As a Percentage of Total Revenue

Year Ended December 31,	1997	1998	**1999**
Revenue:			
Service	97%	95%	**95%**
Product	3	5	**5**
Total revenue	100	100	**100**
Cost of revenue:			
Service	39	46	**47**
Product	–	–	**1**
Total cost of revenue	39	46	**48**
Gross margin	61	54	**52**
Operating expenses:			
Research and development	10	14	**17**
Selling, general and administrative	19	26	**29**
Amortization of deferred stock option compensation	–	1	**1**
Total operating expenses	29	41	**47**
Income from operations	32	13	**5**
Interest income, net	–	1	**2**
Income before income taxes	32	14	**7**
Provision for income taxes	6	5	**3**
Net income	26%	9%	**4%**

Comparison of Years Ended December 31, 1997, 1998 and 1999

Revenue

Total revenue increased 71% from $14.4 million in 1997 to $24.6 million in 1998, and an additional 62% to $39.9 million in 1999. Microsoft accounted for 39%, 79% and 88% of total revenue in 1997, 1998 and 1999, respectively. Revenue outside of North America totaled $4.3 million in 1997, $954,000 in 1998 and $1.2 million in 1999. The decrease in international revenue from 1997 to 1998 correlates with the corresponding increase in Microsoft revenue resulting from the shift from working directly with semiconductor vendors to working with Microsoft for the benefit of those customers during this period. The increase in international revenue from 1998 to 1999 is the result of an increase in the number and size of software integration service and product contracts with OEMs.

Service Revenue. Service revenue increased 67% from $14.0 million in 1997 to $23.4 million in 1998, and an additional 63% to $38.1 million in 1999. The increases in service revenue for all periods were due to the increasing number and size of service projects and related hiring of engineering personnel to fulfill project requirements. As a percentage of total revenue, service revenue did not change materially.

Product Revenue. Product revenue increased 217% from $384,000 in 1997 to $1.2 million in 1998, and an additional 52% to $1.9 million in 1999. The increases in product revenue from 1997 to 1999 resulted from the expansion of product offerings from software applications for handheld PCs to intelligent computing device integration tool kits and CEValidator quality assurance test suites. As a percentage of total revenue, product revenue did not change materially.

Cost of Revenue

Cost of Service Revenue. Cost of service revenue increased 98% from $5.6 million in 1997 to $11.0 million in 1998, and an additional 70% to $18.8 million in 1999. These increases resulted from the hiring and training of additional employees to support our growing customer base. At December 31, 1997, 1998 and 1999, we had 87, 152 and 222 employees, respectively, engaged in engineering consulting. Cost of service revenue as a percentage of related service revenue was 40% in 1997, 47% in 1998 and 49% in 1999. The increases in cost of service revenue as a percentage of related service revenue reflect higher personnel costs related to the competitive employee recruiting and retention pressures in the greater-Seattle area, as well as higher facilities and depreciation costs associated with expansion.

Cost of Product Revenue. Cost of product revenue increased 113% from $78,000 in 1997 to $166,000 in 1998, and an additional 186% to $475,000 in 1999. Cost of product revenue as a percentage of related product revenue was 20% in 1997, 14% in 1998 and 26% in 1999. The decrease in product cost of sales as a percent of product revenue from 1997 to 1998 relates to a change in mix from pre-package applications sales in 1997 to royalty revenue earned from the bundling of software applications in 1998. The increase in product cost of sales as a percentage of product revenue from 1998 to 1999 relates to a change in mix of product sales from royalties received from original equipment manufacturers for licenses of applications in 1998 to a higher proportion of pre-packaged bSquare and third-party applications in 1999.

Operating Expenses

Research and Development. Research and development expenses increased 161% from $1.4 million in 1997 to $3.6 million in 1998, and an additional 84% to $6.7 million in 1999. These increases relate primarily to the increase in the number of software developers and quality assurance personnel hired to expand our product offerings and to support our product development and testing activities. Research and development expenses represented 10% of our total revenue in 1997, 14% in 1998 and 17% in 1999. The increases in research and development expenses as a percentage of total revenue primarily reflect the more rapid investment in our research and development activities compared to the growth of our revenue during these periods. We anticipate that research and development expenses will continue to increase in absolute dollars in future periods.

Selling, General and Administrative. Selling, general and administrative expenses increased 136% from $2.7 million in 1997 to $6.4 million in 1998, and an additional 79% to $11.5 million in 1999. These increases resulted primarily from our investment in finance, executive, administration, sales and marketing infrastructure, both domestically and internationally, which included significant personnel-related expenses, travel expenses and related facility and equipment costs, as well as increased marketing activities, including trade shows, public relations and other promotional expenses. Selling, general and administrative expenses represented 19% of our total revenue in 1997, 26% in 1998 and 29% in 1999. The increases in selling, general and administrative expenses as a percentage of total revenue primarily reflects the more rapid investment in our administrative and sales and marketing infrastructure compared to the growth of our revenue during these periods. During the fourth quarter of 1998, we opened sales offices in Munich, Germany and Tokyo, Japan. To establish and operate these offices, we invested $502,000 in 1998 and $1.9 million in 1999, which are included in the expense amounts above. We anticipate that selling, general and administrative expenses will continue to increase in absolute dollars in future periods as we expand our sales and marketing staff both internationally and domestically, as well as incur expenses associated with being a public company.

Amortization of Deferred Stock Option Compensation. We recorded amortization of deferred stock option compensation of $81,000 in 1997, $171,000 in 1998 and $583,000 in 1999, resulting from stock option exercises at prices below the deemed fair market value of our common stock when we were a private company.

Interest Income (Expense), Net. Interest income (expense), net consists of earnings on our cash, cash equivalents and short-term investment balances offset by interest expense associated with debt obligations. Interest income (expense), net was $(12,000) in 1997, $319,000 in 1998 and $911,000 in 1999. These increases resulted from higher average cash, cash equivalent and short-term investment balances over the prior year.

Income Taxes. Our provision for federal, state and international income taxes was $746,000 for 1997, $1.2 million for 1998 and $1.1 million for 1999, yielding effective rates of 16.4%, 34.1% and 39.4% in 1997, 1998 and 1999, respectively. We were taxed as a subchapter S corporation until October 15, 1997, when our shareholders elected to convert to a C corporation. Accordingly, taxes on our income were the responsibility of the shareholders until the conversion. The increase in the effective tax rate in 1999 over 1998 was due primarily to the effect of the non-deductibility of losses from our international operations.

Liquidity and Capital Resources

Since our inception through September 1999, we financed our operations and capital expenditures primarily through cash flow from operations. As of December 31, 1999, we had $82.4 million of cash, cash equivalents and short-term investments. This represents an increase of $75.5 million over December 31, 1998. In October 1999, we completed an initial public offering of 4,000,000 shares of common stock and raised $54.4 million, net of offering costs. In addition, in September 1999, we sold 1,518,378 shares of our common stock to Vulcan Ventures for approximately $18.7 million. In January 1998, we issued mandatorily redeemable convertible preferred stock from which we received net proceeds of approximately $14.3 million. Concurrent with this transaction, we repurchased 3,333,333 shares of our common stock for an aggregate of $6.0 million. To a lesser extent, we have financed software system purchases through traditional financing arrangements. Our working capital at December 31, 1998 was $10.3 million compared to $81.2 million at December 31, 1999.

Our operating activities resulted in net cash inflows of $4.3 million in 1997, $188,000 in 1998 and $9.8 million in 1999. The sources of cash were primarily income from operations and increases in accounts payable and accrued liabilities, partially offset by increases in accounts receivable.

Investing activities used cash of $1.4 million in 1997, $3.7 million in 1998 and $32.8 million in 1999. Investing activities for 1997 and 1998 were primarily purchases of capital equipment. Investing activities in 1999 included $25.8 million in purchases of short-term investments and $7.0 million in capital equipment.

Financing activities used $775,000 in 1997, primarily for shareholder draws and repayment of long-term obligations. Financing activities generated $6.5 million in 1998, primarily through the issuance of mandatorily convertible preferred stock, partially offset by repayment of shareholder loans and the $6.0 million repurchase of shares of common stock. Financing activities in 1999 generated $72.7 million due to the net proceeds from the initial public offering and from the sale of common stock to Vulcan Ventures.

We have a working capital revolving line of credit with Imperial Bank that is secured by our accounts receivable. This facility allows us to borrow up to the lesser of 80% of our eligible accounts receivable or $5.0 million and bears interest at the bank's prime rate, which was 8.50% at December 31, 1999. The facility expires in July 2000. The agreement under which the line of credit was established contains certain covenants, including a provision requiring us to maintain specified financial ratios. We were in compliance with these covenants at December 31, 1999, and at that time there were no borrowings outstanding under this credit facility. We also maintain with Imperial Bank a $1.5 million term loan for equipment purchases, which bears interest at the bank's prime rate plus 0.25%, and a $4.0 million term loan for leasehold improvement purchases, which bears interest at the bank's prime rate plus 0.50%. These facilities operate as a revolver through June 2000, after which time any outstanding balances must be paid over 36-month and 60-month terms, respectively. These loans also require us to comply with certain financial covenants, including a requirement that we maintain certain financial ratios. We were in compliance with these covenants at December 31, 1999, and at that time there were no borrowings outstanding under these facilities.

As of December 31, 1999, our principal commitments consisted of obligations outstanding under operating leases. In October 1999, we began leasing approximately 126,000 square feet in a single facility located in Bellevue, Washington pursuant to a lease which expires in 2009. The annual cost of this lease is approximately $3.0 million, subject to annual adjustments. Although we have no other material commitments, we anticipate an increase in our capital expenditures and lease commitments consistent with our anticipated growth in our operations, infrastructure and personnel.

We currently anticipate that we will continue to experience significant increases in our operating expenses for the foreseeable future as we enter new markets for our products and services, increase research and development activities and sales and marketing activities, develop new distribution channels and broaden our professional service capabilities. We believe that our existing cash and cash equivalents and available bank borrowings will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. Although we believe that we will be able to meet our anticipated cash needs after that time from cash generated from operations and do not currently anticipate the need to raise additional capital, if we do seek to raise additional capital, there can be no assurance that additional financing will be available on acceptable terms, if at all. We may use a portion of our cash to acquire additional businesses, products and technologies or to establish joint ventures that we believe will complement our current or future business. However, we have no specific plans, agreements or commitments to do so, and are not currently engaged in any negotiations for any such acquisition or joint venture. Pending such uses, we will invest our surplus cash in government securities and other short-term, investment grade, interest-bearing instruments.

> > > Impact of the Year 2000

Even though we have not experienced any immediate adverse impact from the transition to the year 2000, it is possible that other dates in the year 2000 may further affect computer software and systems. While we believe that all of our systems are year 2000 compliant, we may discover problems during 2000 that may require expenditures in order for our computer and software systems to be upgraded, modified or replaced. In addition, we do not currently have any information concerning the year 2000 compliance status of our customers or other parties with whom we do business. It is possible that some of the internal systems of our customers or other parties with whom we do business have already been or will be negatively affected by the year 2000 date change. We currently have no contingency plan to manage any year 2000 issues that may arise.

> > > Recent Accounting Pronouncements

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-1 (SOP 98-1), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," which establishes guidelines for the accounting for the costs of all computer software developed or obtained for internal use. We were required to adopt SOP 98-1 for the fiscal year beginning January 1, 1999. Our adoption of SOP 98-1 did not have a material impact on our financial statements.

In April 1998, the American Institute of Public Accountants issued Statement of Position 98-5 (SOP 98-5), "Reporting on the Costs of Start-up Activities." SOP 98-5, which is effective for fiscal years beginning after December 15, 1998, provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred. The implementation of SOP 98-5 did not have a material impact on our financial position or results of operations.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as a part of a hedge transaction and, if it is, the type of hedge transaction. This statement is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. We do not use derivative instruments, therefore the adoption of this statement will not have any effect on our results of operations or financial position.

In December 1999, SEC Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements," was issued. This pronouncement summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition. We are required to adopt SAB 101 for the year ended December 31, 2001. We are currently reviewing the requirements of SAB 101 and assessing its impact on our financial statements.

Report of Independent Public Accountants

To bSquare Corporation:

We have audited the accompanying consolidated balance sheets of bSquare Corporation and subsidiaries as of December 31, 1999 and 1998, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the financial position of bSquare Corporation and subsidiaries as of December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Seattle, Washington
January 21, 2000

Consolidated Balance Sheets

December 31,	1998	**1999**
> > > **Assets**		
Current assets:		
Cash and cash equivalents	$ 5,324	**$55,029**
Short-term investments	1,582	**27,368**
Accounts receivable, net of allowance for doubtful accounts of $67 in 1998, and $142 in 1999	5,487	**4,203**
Prepaid expenses and other current assets	526	**1,664**
Total current assets	12,919	**88,264**
Furniture, equipment and leasehold improvements, net	3,061	**7,150**
Deposits and other assets	178	**210**
Total assets	$16,158	**$95,624**
> > > **Liabilities and Shareholders' Equity (Deficit)**		
Current liabilities:		
Current portion of long-term liabilities	$ 157	**$ 157**
Accounts payable	676	**579**
Accrued compensation	1,331	**2,274**
Accrued expenses	308	**2,959**
Deferred revenue	167	**1,117**
Total current liabilities	2,639	**7,086**
Long-term obligations	400	**–**
Total liabilities	3,039	**7,086**
Commitments and contingencies (Note 7)		
Mandatorily redeemable convertible Series A preferred stock, no par value: Authorized 10,000,000 shares, issued and outstanding, 8,333,333 shares in 1998 and no shares in 1999, preference in liquidation of $15,000,000	14,417	**–**
Shareholders' equity (deficit):		
Common stock, no par value: Authorized 50,000,000 shares, issued and outstanding, 18,161,605 shares in 1998, and 32,294,833 in 1999	2,123	**90,842**
Deferred stock option compensation	(401)	**(868)**
Cumulative foreign currency translation adjustment	5	**(15)**
Accumulated deficit	(3,025)	**(1,421)**
Total shareholders' equity (deficit)	(1,298)	**88,538**
Total liabilities and shareholders' equity	$16,158	**$95,624**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Income and Comprehensive Income

Year Ended December 31,	1997	1998	**1999**
Revenue:			
Service	$14,021	$23,393	**$38,082**
Product	384	1,219	**1,856**
Total revenue	14,405	24,612	**39,938**
Cost of revenue:			
Service	5,566	11,039	**18,819**
Product	78	166	**475**
Total cost of revenue	5,644	11,205	**19,294**
Gross profit	8,761	13,407	**20,644**
Operating expenses:			
Research and development	1,391	3,628	**6,658**
Selling, general and administrative	2,725	6,438	**11,522**
Amortization of deferred stock option compensation	81	171	**583**
Total operating expenses	4,197	10,237	**18,763**
Income from operations	4,564	3,170	**1,881**
Interest income (expense)	(12)	319	**911**
Income before income taxes	4,552	3,489	**2,792**
Provision for income taxes	746	1,189	**1,101**
Net income	$ 3,806	$ 2,300	**$ 1,691**
Foreign currency translation adjustment	–	(5)	**20**
Comprehensive net income	$ 3,806	$ 2,295	**$ 1,711**
Basic earnings per share	$ 0.18	$ 0.12	**$ 0.06**
Weighted average shares outstanding used to compute basic earnings per share	21,400	18,372	**27,858**
Diluted earnings per share	$ 0.17	$ 0.08	**$ 0.06**
Weighted average shares outstanding to compute diluted earnings per share	21,781	27,475	**30,539**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Shareholders' Equity (Deficit)

	Common Stock		Deferred Stock Option Compensation	Cumulative Foreign Currency Translation Adjustment	Retained Earnings (Accumulated Deficit)	Total Shareholders' Equity (Deficit)
	Shares	Amount				
Balance, December 31, 1996	22,106,000	$ 16	$ –	$ –	$ 908	$ 924
Issuance of common stock for services rendered	500,000	25	–	–	–	25
Repurchase of common stock	(1,231,000)	(46)	–	–	–	(46)
Shareholder note payable on S to C Corporation conversion	–	–	–	–	(2,000)	(2,000)
Shareholder draws	–	–	–	–	(460)	(460)
Net income from January 1, 1997 to October 15, 1997	–	–	–	–	3,670	3,670
Conversion from S corporation to C corporation	–	2,118	–	–	(2,118)	–
Issuance of compensatory stock options	–	653	(653)	–	–	–
Amortization of deferred stock option compensation	–	–	81	–	–	81
Net income from October 16, 1997 to December 31, 1997	–	–	–	–	136	136
Balance, December 31, 1997	21,375,000	2,766	(572)	–	136	2,330
Repurchase of common stock	(3,333,333)	(649)	–	–	(5,351)	(6,000)
Exercise of stock options	119,938	6	–	–	–	6
Amortization of deferred stock option compensation	–	–	171	–	–	171
Foreign currency translation adjustment	–	–	–	5	–	5
Accretion on mandatorily redeemable convertible preferred stock	–	–	–	–	(110)	(110)
Net income	–	–	–	–	2,300	2,300
Balance, December 31, 1998	18,161,605	2,123	(401)	5	(3,025)	(1,298)
Exercise of stock options	**281,517**	**77**	**–**	**–**	**–**	**77**
Issuance of compensatory stock options	**–**	**1,050**	**(1,050)**	**–**	**–**	**–**
Amortization of deferred stock option compensation	**–**	**–**	**583**	**–**	**–**	**583**
Foreign currency translation adjustment	**–**	**–**	**–**	**(20)**	**–**	**(20)**
Accretion on mandatorily redeemable convertible preferred stock	**–**	**–**	**–**	**–**	**(87)**	**(87)**
Issuance of common stock (net of offering costs of $13)	**1,518,378**	**18,689**	**–**	**–**	**–**	**18,689**
Issuance of common stock in connection with the initial public offering (net of offering costs of $5,601)	**4,000,000**	**54,399**	**–**	**–**	**–**	**54,399**
Conversion of mandatorily redeemable convertible preferred stock into shares of common stock	**8,333,333**	**14,504**	**–**	**–**	**–**	**14,504**
Net income	**–**	**–**	**–**	**–**	**1,691**	**1,691**
Balance, December 31, 1999	**32,294,833**	**$90,842**	**$ (868)**	**$(15)**	**$(1,421)**	**$88,538**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

Year Ended December 31,	1997	1998	1999
Cash Flows From Operating Activities			
Net income	$ 3,806	$ 2,300	**$ 1,691**
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	328	948	**2,215**
Deferred income taxes	262	(387)	**(922)**
Stock and stock option compensation	106	171	**583**
Amortization of deferred financing costs	–	14	**13**
Changes in operating assets and liabilities:			
Accounts receivable	(2,109)	(2,786)	**1,283**
Prepaid expenses and other current assets	(90)	(193)	**(184)**
Accounts payable and accrued expenses	1,111	960	**4,282**
Income taxes	484	(221)	**(146)**
Deferred revenue	389	(618)	**950**
Net cash provided by operating activities	4,287	188	**9,765**
Cash Flows From Investing Activities			
Purchases of furniture, equipment and leasehold improvements	(1,413)	(2,117)	**(6,987)**
Purchase of short-term investments, net	–	(1,582)	**(25,786)**
Net cash used in investing activities	(1,413)	(3,699)	**(32,773)**
Cash Flows From Financing Activities			
Repayment of shareholder notes payable	(256)	(1,743)	**–**
Payments on long-term obligations	–	(26)	**(446)**
Repurchase of common stock	(46)	(6,000)	**–**
Deferred financing costs	(13)	(2)	**(25)**
Proceeds from exercise of stock options	–	6	**77**
Shareholders' draws	(460)	–	**–**
Net proceeds from issuance of mandatorily redeemable convertible preferred stock	–	14,307	**–**
Net proceeds from sale of common stock	–	–	**18,689**
Net proceeds from initial public offering	–	–	**54,399**
Net cash provided by (used in) financing activities	(775)	6,542	**72,694**
Effect of exchange rate changes on cash	–	7	**19**
Net increase in cash and cash equivalents	2,099	3,038	**49,705**
Cash and cash equivalents, beginning of period	187	2,286	**5,324**
Cash and cash equivalents, end of period	$ 2,286	$ 5,324	**$ 55,029**

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

1 : Summary of Significant Accounting Policies

Description of Business

bSquare Corporation, a Washington corporation, and its subsidiaries (collectively the Company) provides a variety of software products and services that facilitate the integration of the Microsoft Windows based operating systems with a wide variety of intelligent computing devices. The Company works with semiconductor vendors and original equipment manufacturers to provide software products and engineering services for the development of intelligent computing devices.

The Company helps enable the rapid and low-cost deployment of intelligent computing devices by providing a variety of software products and services for the development, integration and deployment of Windows-based operating systems with industry-specific applications. The Company also develops software applications that are licensed to end users to provide intelligent computing devices with additional functionality. The Company markets and supports its products and provides services on a worldwide basis through a direct sales force augmented by distributors.

Certain Significant Risks and Uncertainties

The Company operates in the software industry, and accordingly, can be affected by a variety of factors. For example, management of the Company believes that any of the following factors could have a significant negative effect on the Company's future financial position, results of operations and cash flows: unanticipated fluctuations in quarterly operating results; failure of the market for Windows CE operating system to develop fully; failure of the market for intelligent computing devices to develop fully; adverse changes in the Company's relationship with Microsoft; failure to secure contracts with market-leading original equipment manufacturers; intense competition; failure to attract and retain key personnel; failure to protect intellectual property; risks associated with international operations; inability to manage growth; and litigation or other claims against the Company.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated. Accounts denominated in foreign currencies have been re-measured into the functional currency, using the U.S. dollar as the functional currency.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Earnings Per Share

In accordance with Statement of Financial Accounting Standards (SFAS) No. 128, "Computation of Earnings Per Share," basic earnings per share is computed by dividing net income available to common shareholders (net income less accretion of mandatorily redeemable convertible preferred stock) by the weighted average number of shares of common stock outstanding during the period. Dilutive earnings per share is computed by dividing net income by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Common equivalent shares consist of the shares of common stock issuable upon the conversion of the mandatorily redeemable convertible preferred stock (using the if-converted method) and shares issuable upon the exercise of stock options and warrants (using the treasury stock method); common equivalent shares are excluded from the calculation if their effect is antidilutive. The Company has not had any issuances or grants for nominal consideration as defined under Staff Accounting Bulletin 98.

Cash and Cash Equivalents

Cash and cash equivalents include demand deposits, money market accounts and all highly liquid debt instruments with an original maturity date of three months or less.

Short-term Investments

The Company's short-term investments consist primarily of investment-grade marketable securities, which are classified as held to maturity and recorded at amortized cost. Due to the short-term nature of these investments, changes in market interest rates would not have a significant impact on the fair value of these securities that are carried at amortized cost, which approximates fair value.

At December 31, 1999 and 1998, all short-term investments had a contractual maturity of two years or less.

Financial Instruments and Concentrations of Credit Risk

The Company has the following financial instruments: cash and cash equivalents, short-term investments, accounts receivable, accounts payable, accrued liabilities, bank lines of credit and standby letters of credit. The carrying value of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and accrued liabilities approximate fair value based on the liquidity of these financial instruments or based on their short term nature. The carrying value of bank lines of credit, and standby letters of credit approximates fair value based on the market interest rates available to the Company for debt of similar risk and maturities.

The Company performs initial and ongoing evaluations of its customers' financial position, and generally extends credit on open account, requiring collateral as deemed necessary. The Company maintains allowances for potential credit losses.

Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are stated at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives, as follows: office furniture and equipment – four years; computer equipment – three years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life. Maintenance and repairs are expensed as incurred. When properties are retired or otherwise disposed, gains or losses are reflected in the income statement. When facts and circumstances indicate that the cost of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the asset to projected future cash flows. Upon indication that the carrying value of such assets may not be recoverable, the Company would recognize an impairment loss by a charge against current operations.

Software Development Costs

Under the criteria set forth in Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," capitalization of software development costs begins upon the establishment of technological feasibility of the product, which the Company has defined as the completion of beta testing of a working product. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs require considerable judgment by management with respect to certain external factors, including, but not limited to, anticipated future gross product revenue, estimated economic life and changes in software and hardware technology. Amounts that could have been capitalized under this statement after consideration of the above factors were immaterial and, therefore, no software development costs have been capitalized by the Company to date.

Research and Development

Research and development costs are expensed as incurred.

Income Taxes

The Company computes income taxes using the asset and liability method, under which deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred tax assets and liabilities are measured using currently enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amounts expected to be realized.

Foreign Currency Translation

The functional currency of foreign subsidiaries is the local currency. Accordingly, assets and liabilities are translated into U.S. Dollars at exchange rates in effect at the balance sheet date and income and expense accounts at the average exchange rates during the year. Resulting translation adjustments are recorded as a separate component of

shareholders' equity. The net gains and losses resulting from foreign currency transactions are recorded in the consolidated statements of income in the period incurred and were not significant for any of the periods presented.

Revenue Recognition

The Company's revenue recognition policy is in compliance with the provisions of the American Institute of Certified Public Accountants' Statement of Position 97-2, "Software Revenue Recognition." Service revenue is derived from software porting and development contracts. Product revenue consists of licensing fees from software application products and operating system and software development tool products. The Company's customers consist of software companies, original equipment manufacturers, distributors and end users.

The Company's revenue is recognized as follows:

> **Time and Material Consulting Contracts.** The Company recognizes revenue as services are rendered.

> **Fixed-Price Consulting Contracts.** Service revenue from fixed-price contracts is recognized on the percentage-of-completion method, measured by the cost incurred to date to the estimated total cost for the contract. This method is used as management considers expended costs to be the best available measure of contract performance. Contract costs include all direct labor, material and any other costs related to contract performance. Selling, general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability may result in revisions in the estimate of total costs. Any required adjustments due to these changes are recognized in the period in which such revisions are determined.

> **Product Revenue.** Product revenue consists principally of fees from the licensing and sale of software products. Product licensing fees, including advanced production royalty payments, are generally recognized when a customer license agreement has been executed, the software has been shipped, remaining obligations are insignificant and collection of the resulting account receivable is probable. The Company recognizes license royalty income as it is reported by the reseller when it ships its product to distributors.

Deferred revenue consists of deposits received from customers and unamortized service contract revenue.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

> > > 2 : Cash and Short-term Investments

The Company's cash, cash equivalent and short-term balances consist of the following:

December 31,	1998	**1999**
Cash and equivalents:		
Cash	$ 220	**$ 90**
Money market funds	5,104	**8,056**
Municipal certificates	–	**46,883**
	$5,324	**$55,029**
Short-term investments:		
Commercial paper	$1,582	**$ 3,064**
Corporate notes and bonds	–	**12,580**
Municipal securities	–	**11,724**
	$1,582	**$27,368**

3 : Furniture, Equipment and Leasehold Improvements

Major classifications of furniture, equipment and leasehold improvements consist of the following:

December 31,	1998	**1999**
Computer equipment and system software	$ 2,450	**$ 3,508**
Office furniture and equipment	667	**1,250**
Leasehold improvements	1,040	**4,443**
Construction in progress	118	**–**
	4,275	**9,201**
Less: accumulated depreciation and amortization	(1,214)	**(2,051)**
	$ 3,061	**$ 7,150**

4 : Income Taxes

The Company was a Subchapter S Corporation for income tax purposes from inception to October 15, 1997. Effective October 16, 1997, the Company converted to a C Corporation and was thereafter responsible for U.S. federal income taxes. A net deferred tax liability of $445, primarily related to the required conversion for income tax purposes from the cash basis method to the accrual basis method of accounting, was recorded at the conversion date to reflect the Company's net taxable temporary differences.

In addition, in accordance with Staff Accounting Bulletin Topic 4.B., the Company has reclassified accumulated earnings generated prior to the date of conversion to C corporation status from retained earnings to common stock and additional paid in capital.

The provision for income taxes consisted of the following:

Year Ended December 31,	1997	1998	**1999**
Current			
U.S. Current	$484	$1,549	**$1,995**
International	–	27	**28**
U.S. Deferred	262	(387)	**(922)**
Total tax provision	$746	$1,189	**$1,101**

The components of net deferred tax assets (liabilities) consisted of the following at December 31:

December 31,	1998	**1999**
Deferred income tax asset:		
Depreciation	$ 41	**$ 88**
Accrued compensation and benefits	206	**472**
Deferred revenue	57	**213**
Cash to accrual basis conversion	(111)	**(111)**
Other, net	44	**386**
	$ 237	**$1,048**
Deferred income taxes payable:		
Cash to accrual basis conversion	$(111)	**$ –**
	$(111)	**$ –**

The provision for income taxes differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pre-tax income, as a result of the following:

Year Ended December 31,	1997	1998	**1999**
Taxes at the U.S. statutory rate	34.0%	34.0%	**34.0%**
Increase (decreases) in income taxes resulting from:			
Conversion from an S Corporation to C Corporation	9.8	–	**–**
Shareholder responsibility for taxes associated with S Corporation status	(27.4)	–	**–**
Research and development tax credit	(0.8)	(6.2)	**(7.2)**
International operations	–	4.5	**14.3**
Tax exempt interest	–	–	**(5.5)**
Other, net	0.8	1.8	**3.8**
	16.4%	34.1%	**39.4%**

5 : Shareholder Notes Payable

The Company was a Subchapter S Corporation for income tax purposes from inception to October 15, 1997. Effective October 16, 1997, the Company converted to a C Corporation. In connection with the conversion, the Company issued notes payable totaling $2.0 million to the shareholders. Interest accrued at the applicable federal long-term rate under Section 1274 of the Internal Revenue Code of 1986, as amended. Although the notes were not due until December 2002, or earlier if certain conditions were met, the Company paid in full these notes and related accrued interest on January 30, 1998.

6 : Bank Line of Credit and Notes Payable

At December 31, 1999, the Company had available a $5.0 million secured domestic revolving line of credit, $1.5 million term loan for the purchase of equipment and a $4.0 term loan for leasehold improvements. Interest accrues at the bank's prime rate for the revolving line of credit, the bank's prime rate plus 0.25% for the equipment term loan and the bank's prime rate plus 0.5% for the leasehold term loan. The facility fee is $25. Restrictive terms of the lines require, among other requirements, that the Company maintain a minimum quick ratio, tangible net worth and debt service ratio, and limits the Company's ability to pay dividends without the lender's consent. The line of credit is secured by substantially all of the assets of the Company. As of December 31, the Company had $464 in standby letters of credit issued and outstanding under the domestic revolving line of credit.

7 : Commitments and Contingencies

The Company leases its office space under non-cancelable operating leases that expire at various dates through 2009. During the years ending December 31, 1997, 1998, and 1999, rental expense was $420, $980, and $3,347, respectively. Minimum rental commitments under non-cancelable operating leases at December 31, 1999 are as follows:

2000	$ 3,081
2001	2,978
2002	2,948
2003	3,044
2004	3,090
Thereafter	15,572
	$30,713

In January 1999, the Company signed a ten-year lease for a new corporate headquarters in Bellevue, Washington, which commenced in October 1999. The Company has the option to extend the lease for four additional periods of five years each. The Company must provide a $667 letter of credit as security for the lease. If certain working capital requirements are not met on the commencement date, the Company must provide an additional $333 letter of credit. The letter of credit may be reduced annually by specified amounts in the lease agreement upon the Company's achieving certain economic goals.

> > > 8 : Mandatorily Redeemable Convertible Preferred Stock

The Company has authorized 10.0 million shares of convertible preferred stock. The Board of Directors has the authority to establish and define, in one or more series, the price, rights, preferences and dividends of authorized but unissued shares of preferred stock.

On January 30, 1998, the Company issued 8,333,333 shares of Series A Convertible Preferred Stock (Preferred Stock) at $1.80 per share. Total proceeds, net of offering costs, approximated $14.3 million. Concurrent with this transaction, the Company repurchased 3,333,333 shares of the Company's common stock from its founders for $6.0 million.

The rights and preferences of the preferred stock are as follows:

- In the event of any liquidation, dissolution or winding up of the Company, the holders of Series A Preferred Stock would be entitled to receive the greater of: (i) an amount in cash equal to $1.80 per share (adjusted for stock splits, stock dividends and the like) or (ii), cash in an amount equal to the portion of the assets of the Company remaining for distribution to shareholders which such shareholder would have received if each share of Series A Preferred Stock held had been converted into the number of shares of common stock issuable upon the conversion of a share of Series A Preferred Stock immediately prior to any liquidation, dissolution or winding up of the Company.
- The preferred stock is voluntarily convertible at any time at the option of the holder into shares of the Company's common stock at a one-for-one conversion. The preferred stock is automatically convertible upon closing of a Qualified Public Offering, as defined in the agreement.
- Any time following the fifth anniversary of the closing, holders of the preferred stock have the right to cause the Company to redeem up to 50% of the preferred stock at the original purchase price. Any time following the sixth anniversary of the closing, the holders shall have the right to cause the Company to redeem up to 100% of the preferred stock at the original purchase price.
- The preferred stock converts at a one-for-one conversion rate, and is adjusted in certain circumstances to prevent dilution of the preferred shareholder's ownership interest.
- The preferred shareholders have the same voting rights and voting powers as common shareholders.

The preferred shares were converted into shares of the Company's common stock in conjunction with the Company's initial public offering on October 20, 1999.

> > > 9 : Shareholders' Equity

Initial Public Offering

On October 20, 1999, the Company issued 4,000,000 shares of its common stock at an initial public offering price of $15.00 per share. Also sold in this offering were 600,000 shares held by selling shareholders upon exercise of the underwriters' overallotment options. The net proceeds to the Company from the offering, net of offering costs of approximately $5.6 million were approximately $54.4 million. Concurrent with the initial public offering, each outstanding share of the Company's mandatorily redeemable preferred stock was automatically converted into common stock.

Stock Purchase Agreement

On August 18, 1999, the Company entered into a stock purchase agreement to sell 1,518,378 shares of common stock to Vulcan Ventures for approximately $18.7 million.

Common Stock Reserved For Future Issuance

At December 31, 1999, the Company has reserved the following shares of common stock for future issuance:

Employee Stock Purchase Plan	**1,500,000**
Stock Option Plan	**1,773,980**
	3,273,980

> > > 10 : Employee Benefit Plans

Stock Options

In May 1997, the Company adopted the Amended and Restated Stock Option Plan (the Plan). Under the Plan, the Board of Directors may grant nonqualified stock options at a price determined by the Board, not to be less than 85% of the fair market value of the common stock. 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 this program 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. A summary of stock option activity follows:

			Price Per Share	
	Number of Options Outstanding	Available for Issuance	Weighted Average Exercise Price	Range
Balance, December 31, 1996	–	–	–	–
Authorized	–	2,500,000	–	–
Granted	1,750,100	(1,750,100)	$0.08	$0.05 – $ 1.00
Exercised	–	–	–	–
Canceled	(69,300)	69,300	$0.05	$0.05 – $ 0.05
Balance, December 31, 1997	1,680,800	819,200	$0.08	$0.05 – $ 1.00
Authorized	–	1,125,000	–	–
Granted	1,108,150	(1,108,150)	$1.15	$1.00 – $ 1.80
Exercised	(119,938)	–	$0.05	$0.05 – $ 0.05
Canceled	(128,850)	128,850	$0.34	$0.05 – $ 1.00
Balance, December 31, 1998	2,540,162	964,900	$0.54	$0.05 – $ 1.80
Authorized	–	2,000,000	–	–
Granted	1,345,795	(1,345,795)	$7.24	$1.44 – $45.06
Exercised	(281,517)	–	$0.36	$0.05 – $ 1.00
Canceled	(154,875)	154,875	$0.82	$0.05 – $10.00
Balance, December 31, 1999	**3,449,565**	**1,773,980**	**$3.15**	**$0.05 – $45.06**

The following table summarizes information concerning currently outstanding and exercisable options at December 31, 1999:

	Outstanding		Exercisable	
Range of Exercise Price	Number of Options	Weighted Average Remaining Contractual Life (Years)	Number of Options	Weighted Average Exercise Price
$ 0.05 – $ 1.00	1,928,170	7.6	691,255	$ 0.39
$ 1.44 – $ 2.50	860,000	9.1	370,000	$ 1.51
$10.00 – $12.00	604,895	9.7	5,000	$10.00
$30.93 – $45.06	56,500	9.8	–	–
	3,449,565	**8.4**	**1,066,255**	**$ 0.82**

Had compensation expense been recognized on stock options issued based on the fair value of the options at the date of the grant and recognized over the vesting period, the Company's net income would have been reduced to the pro forma amounts presented below:

Year Ended December 31,	1997	1998	**1999**
Net income, as reported	$3,806	$2,300	**$ 1,691**
Supplemental pro forma compensation expense under SFAS No. 123	(12)	(82)	**(1,351)**
Pro forma net income	$3,794	$2,218	**$ 340**
Pro forma basic earnings per share	$ 0.18	$ 0.12	**$ 0.01**

The fair value of options granted in 1997, 1998 and 1999 of $0.03, $0.25 and $4.89, respectively, has been estimated at the date of grant using the Black-Scholes method with the following weighted-average assumptions:

Year Ended December 31,	1997	1998	**1999**
Dividend yield	0%	0%	**0%**
Expected life (years)	5	5	**5**
Expected volatility	0%	0%	**57%**
Risk-free interest rate	6.0%	5.5%	**6.6%**

The effects on pro forma disclosures of applying SFAS No. 123 are not likely to be representative of the effects on pro forma disclosures of future years.

1999 Employee Stock Purchase Plan

On July 21, 1999, the Board of Directors approved the adoption of the Company's 1999 Employee Stock Purchase (the "1999 Purchase Plan"). Under the plan, the Company is authorized to sell up to 1.5 million shares of common stock in a series of eighteen month offerings. The 1999 Purchase Plan permits eligible employees to acquire shares of the Company's common stock through periodic payroll deductions of up to 10% of base cash compensation. The price at which the common stock may be purchased is 85% of the lesser of 1) the fair market value of the Company's common stock on the first day of the applicable offering period or 2) the fair market value of the shares on the purchase date. The initial offering period commenced on the effectiveness of the initial public offering.

Profit Sharing and Deferred Compensation Plan

The Company has a Profit Sharing and Deferred Compensation Plan (Profit Sharing Plan) under Section 401(k) of the Internal Revenue Code of 1986, as amended. Substantially all full-time employees are eligible to participate. The Company, at its discretion, may elect to match the participants' contributions to the Profit Sharing Plan. Participants will receive their share of the value of their investments upon retirement or termination, subject to a vesting schedule. The Company made no matching contributions to the Profit Sharing Plan during 1998 or 1997. During the year ended December 31, 1999, the Company made matching contributions to the Profit Sharing Plan of $514.

Deferred Stock Option Compensation

In connection with the grant of certain stock options to employees and consultants during 1997 and 1999, the Company recorded deferred stock option compensation of $653 and $1.1 million, respectively, representing the difference between the estimated fair value of the common stock for accounting purposes and the option exercise price of such options at the date of grant. Such amount is presented as a reduction of shareholders' equity and amortized, in accordance with FASB Interpretation No. 28, on an accelerated basis over the vesting period of the applicable options (generally four years). During the years ended December 31, 1997, 1998 and 1999, the Company expensed approximately $81, $171, and $583, respectively. The balance will be expensed over the period the options vest. Compensation expense is decreased in the period of forfeiture for any accrued but unvested compensation arising from the early termination of an option holder's services.

Included in the expensed amounts noted above for the year ended December 31, 1999 is $30 related to options granted to a consultant for services rendered. As of December 31, 1999, the consultant had earned 20,833 options to acquire common stock at $1 per share. The Company has recorded the fair value of the options as of the date the options were earned based on a Black-Scholes model utilizing a 50% volatility factor and an expected life of 2 years. During 1999, the agreement was terminated.

> > > 11 : Supplemental Disclosure of Cash Flow Information

Year Ended December 31,	1997	1998	**1999**
Issuance of notes payable for equipment	$ –	$ 473	**$ –**
Cash paid for interest	13	57	**68**
Cash paid for income taxes	–	2,170	**2,520**

All significant non-cash financing activities are listed elsewhere in the financial statements or the notes thereto.

> > > 12 : Significant Customers

Sales to customers, which comprised at least 10% of revenue for the years ended December 31 were as follows:

Year Ended December 31,	1997	1998	**1999**
Microsoft	39%	79%	**88%**
Hitachi	18%	2%	**–**
NEC	17%	3%	**–**
ARM	11%	1%	**–**

As of December 31, 1997, 1998, and 1999, Microsoft represented 73%, 84% and 82% of total accounts receivable, respectively.

In February 1999, the Company signed a two-year agreement with Microsoft Corporation to continue to provide services to Microsoft which extend the capabilities of the Windows CE operating system.

> > > 13 : Geographic and Segment Information

The Company follows the requirements of Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information." As defined in SFAS No. 131, the Company operates in two reportable segments, Service and Products for Windows-based operating systems. The following table summarizes total revenue and long-lived assets attributed to significant countries:

Year Ended December 31,	1997	1998	**1999**
Total revenue:			
United States	$10,065	$23,658	**$38,703**
Japan	2,632	195	**376**
Other Foreign	1,708	759	**859**
Total revenue[1]	$14,405	$24,612	**$39,938**
Long-lived assets:			
United States	$ 1,378	$ 2,795	**$ 6,946**
Japan	–	239	**257**
Germany	–	205	**157**
Total long-lived assets	$ 1,378	$ 3,239	**$ 7,360**

[1] Revenue is attributed to countries based on location of customer invoiced.

bSquare has two operating segments, Services and Products. The Services segment includes design and development of integration tools for the semiconductor vendors and the original equipment manufacturer market. The Product segment derives revenue from licensing of software products to original equipment manufactures and distributing product through resellers. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

The Company does not track assets or operating expenses by operating segments. Consequently, it is not practicable to show assets or operating expenses by operating segments.

> > > 14 : Quarterly Financial Information (Unaudited)

Summarized quarterly financial information for 1998 and 1999 are as follows:

	March 31	June 30	Sept. 30	Dec. 31
1998 Quarter Ended				
Revenue	$5,492	$5,310	$6,579	$7,231
Gross profit	3,089	2,735	3,614	3,969
Income from operations	1,288	416	1,196	270
Net income	$ 856	$ 361	$ 802	$ 281
Net income per share, basic	$ 0.04	$ 0.02	$ 0.04	$ 0.01
Weighted average shares outstanding used to compute basic earnings per share	19,190	18,046	18,113	18,154
1999 Quarter Ended				
Revenue	**$ 8,809**	**$ 9,734**	**$10,033**	**$11,362**
Gross profit	**4,668**	**5,092**	**5,106**	**5,778**
Income from operations	**722**	**726**	**350**	**83**
Net income	**$ 432**	**$ 434**	**$ 262**	**$ 563**
Net income per share, basic	**$ 0.02**	**$ 0.02**	**$ 0.01**	**$ 0.02**
Weighted average shares outstanding used to compute basic earnings per share	**18,197**	**18,215**	**18,583**	**31,394**

> > > 15 : Earnings Per Share

The following is a reconciliation of the numerators and denominators used in computing basic and diluted earnings per share:

Year Ended December 31,	1997	1998	**1999**
Net income (numerator diluted)	$ 3,806	$ 2,300	**$ 1,691**
Less: Accretion of mandatorily redeemable convertible preferred stock	–	(110)	**(87)**
Net income available to common shareholders (numerator basic)	$ 3,806	$ 2,190	**$ 1,604**
Shares (denominator basic):			
Weighted average common shares outstanding	21,400	18,372	**27,858**
Basic earnings per share	$ 0.18	$ 0.12	**$ 0.06**
Shares (denominator diluted):			
Weighted average common shares outstanding	21,400	18,372	**21,169**
Mandatorily redeemable convertible preferred stock	–	7,648	**6,689**
Common stock equivalents	381	1,455	**2,681**
Shares used in computation (denominator diluted)	21,781	27,475	**30,539**
Diluted earnings per share	$ 0.17	$ 0.08	**$ 0.06**

> > > 16 : Subsequent Event

On January 5, 2000, the Company acquired Blue Water Systems, Inc. in a transaction accounted for as a pooling of interests. Blue Water Systems, located in Edmonds, Washington is dedicated to the design of software development toolkits and system integration services for the creation of Windows-based intelligent computing devices. The transaction was effected through the exchange of approximately 261,000 shares of bSquare common stock for all of the issued and outstanding shares of Blue Water Systems.

Corporate Information

Directors

William T. Baxter
Chairman of the Board

Jeffrey T. Chambers
Member, TA Associates

Albert T. Dosser
Senior Vice President,
bSquare

Scot E. Land
Managing Director,
Encompass Ventures

William Larson
Chief Executive Officer
and Chairman of the Board,
Network Associates, Inc.

David M. Moore
Senior Analyst,
Vulcan Northwest, Inc.

Executive Officers

William T. Baxter
President and
Chief Executive Officer

David J. Bialer
General Manager

Albert T. Dosser
Senior Vice President

Brian V. Turner
Senior Vice President,
Operations and
Chief Financial Officer

Donald L. Whitt
General Manager

Vice Presidents

Scott E. Bufkin
Vice President,
Professional
Engineering Services

Diane M. Istvan
Vice President, Legal Affairs

Leila L. Kirske
Vice President, Finance

Christiane M. Liebe
Vice President,
Information Technology

Joseph Notarangelo
Vice President,
Business Development

Thomas S. Schild
Senior Vice President,
Worldwide Sales

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www.chasemellon.com

Legal Counsel
Summit Law Group
Seattle, Washington

Independent Public Accountants
Arthur Andersen LLP
Seattle, Washington

Annual Meeting
The annual meeting of shareholders will be held on Tuesday, May 2, 2000, 10:00 A.M. at bSquare Corporate Headquarters, 3150 139th Avenue SE, Bellevue, WA.

Form 10-K
bSquare files an Annual Report with the Securities and Exchange Commission on Form 10-K. Copies are available from bSquare without charge upon request. Requests should be sent to:
investorrelations@bsquare.com

Stock Exchange Listing
Our common stock is traded on the Nasdaq National Market under the symbol "BSQR."

Market Information
The following table sets forth the high and low quarterly sales prices of our common stock as reported on the Nasdaq National Market since October 20, 1999, the date our common stock commenced trading.

	High	Low
12/31/99	$56.50	$15.00

Dividends
We have never paid cash dividends on our common stock other than the distribution of S corporation earnings prior to October 1997, when we converted to a C corporation. We currently intend to retain any future earnings to fund the development and growth of our business. Therefore, we do not currently anticipate paying any cash dividends in the foreseeable future. In addition, the terms of our current credit facility prohibit us from paying dividends without our lender's consent.