AWARE INC /MA/
Form 10-Q
July 27, 2011

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

# FORM 10-Q

Quarterly Report Pursuant To Section 13 Or 15(d) Of The
Securities Exchange Act of 1934

For the quarter ended June 30, 2011

Commission file number 000-21129

AWARE, INC.
(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Massachusetts | 04-2911026 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

40 Middlesex Turnpike, Bedford, Massachusetts, 01730
(Address of Principal Executive Offices)
(Zip Code)

(781) 276-4000
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES o 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 definition 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 x Non-Accelerated Filer o Smaller Reporting Company o

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

Indicate the number of shares outstanding of the issuer’s common stock as of July 22, 2011:

| Class | Number of Shares Outstanding |
|---|---|
| Common Stock, par value $0.01 per share | 20,573,688 shares |

AWARE, INC.

FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2011

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PART 1. FINANCIAL INFORMATION
ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS
AWARE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)
(unaudited)

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $43,232 | $39,949 |
| Accounts receivable, net | 5,073 | 4,968 |
| Inventories | 1,413 | 1,863 |
| Prepaid expenses and other current assets | 240 | 235 |
| Total current assets | 49,958 | 47,015 |
| | | |
| Property and equipment, net | 6,212 | 6,360 |
| Other assets, net | 17 | 25 |
| Total assets | $56,187 | $53,400 |
| | | |
| LIABILITIES AND STOCKHOLDERS’ EQUITY | | |
| | | |
| Current liabilities: | | |
| Accounts payable | $651 | $565 |
| Accrued expenses | 126 | 118 |
| Accrued compensation | 841 | 1,143 |
| Accrued professional | 278 | 427 |
| Deferred revenue | 1,208 | 944 |
| Total current liabilities | 3,104 | 3,197 |
| | | |
| Long-term deferred revenue | 462 | 320 |
| | | |
| Stockholders’ equity: | | |
| Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding | - | - |
| Common stock, $.01 par value; 70,000,000 shares authorized; issued and outstanding 20,767,661 as of June 30, 2011 and 20,041,863 as of December 31, 2010 | 208 | 200 |
| Additional paid-in capital | 79,780 | 77,373 |
| Accumulated deficit | (27,367) | (27,690) |
| Total stockholders’ equity | 52,621 | 49,883 |
| | | |
| Total liabilities and stockholders’ equity | $56,187 | $53,400 |

The accompanying notes are an integral part of the consolidated financial statements.

AWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|---|---|---|
| Revenue: | | | | |
| Product sales | $3,997 | $3,911 | $9,075 | $8,562 |
| Services | 1,375 | 346 | 2,204 | 555 |
| Royalties | 541 | 714 | 993 | 1,470 |
| Total revenue | 5,913 | 4,971 | 12,272 | 10,587 |
| Costs and expenses: | | | | |
| Cost of product sales | 1,087 | 840 | 2,308 | 1,877 |
| Cost of services | 450 | 74 | 807 | 145 |
| Research and development | 1,810 | 2,082 | 3,770 | 4,117 |
| Selling and marketing | 1,060 | 1,053 | 2,111 | 2,119 |
| General and administrative | 1,789 | 1,416 | 2,986 | 2,818 |
| Total costs and expenses | 6,196 | 5,465 | 11,982 | 11,076 |
| Income (loss) from operations | (283) | (494) | 290 | (489) |
| Other income | - | 325 | - | 325 |
| Interest income | 16 | 21 | 35 | 39 |
| Income (loss) before provision for income taxes | (267) | (148) | 325 | (125) |
| Provision for income taxes | - | - | 2 | 1 |
| Net income (loss) | $(267) | $(148) | $323 | $(126) |
| Net income (loss) per share – basic | $(0.01) | $(0.01) | $0.02 | $(0.01) |
| Net income (loss) per share – diluted | $(0.01) | $(0.01) | $0.02 | $(0.01) |
| Weighted average shares – basic | 20,700 | 19,927 | 20,461 | 19,920 |
| Weighted average shares - diluted | 20,700 | 19,927 | 20,821 | 19,920 |

The accompanying notes are an integral part of the consolidated financial statements.

AWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $323 | $(126) |
| Adjustments to reconcile net income (loss) to net cash provided from (used) in operating activities: | | |
| Depreciation and amortization | 244 | 260 |
| Stock-based compensation | 885 | 548 |
| Increase (decrease) from changes in assets and liabilities: | | |
| Accounts receivable | (105) | (968) |
| Inventories | 450 | (220) |
| Prepaid expenses and other current assets | (5) | 30 |
| Accounts payable | 86 | 337 |
| Accrued expenses, compensation, and professional | (443) | (107) |
| Deferred revenue | 406 | 92 |
| Net cash provided from (used in) operating activities | 1,841 | (154) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (88) | (67) |
| Expenses from sale of assets | - | (100) |
| Purchases of other assets | - | (60) |
| Net cash used in investing activities | (88) | (227) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 1,684 | 2 |
| Shares surrendered by employees to pay taxes related to unrestricted stock | (154) | (161) |
| Net cash provided by (used in) financing activities | 1,530 | (159) |
| Increase (decrease) in cash and cash equivalents | 3,283 | (540) |
| Cash and cash equivalents, beginning of period | 39,949 | 39,669 |
| Cash and cash equivalents, end of period | $43,232 | $39,129 |

The accompanying notes are an integral part of the consolidated financial statements.

AWARE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

A) Basis of Presentation. The accompanying unaudited consolidated balance sheet, statements of operations, and statements of cash flows reflect all adjustments (consisting only of normal recurring items) which are, in the opinion of management, necessary for a fair presentation of financial position at June 30, 2011, and of operations and cash flows for the interim periods ended June 30, 2011 and 2010.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and notes necessary for a complete presentation of our financial position, results of operations and cash flows, in conformity with generally accepted accounting principles. We filed audited financial statements which included all information and notes necessary for such presentation for the three years ended December 31, 2010 in conjunction with our 2010 Annual Report on Form 10-K. This Form 10-Q should be read in conjunction with that Form 10-K.

The results of operations for the interim period ended June 30, 2011 are not necessarily indicative of the results to be expected for the year.

B) Fair Value Measurements. The Financial Accounting Standards Board ("FASB") issued authoritative guidance for fair value measurements, which defines fair value, establishes a framework for measuring fair value, and expands disclosures for assets and liabilities measured at fair value in financial statements. We adopted these provisions on January 1, 2008.

The fair value guidance establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For recognition purposes, on a recurring basis we are required to measure available for sale investments at fair value. We had no available for sale investments as of June 30, 2011 or December 31, 2010.

Our cash and cash equivalents, including money market securities, were $43.2 million and $39.9 million as of June 30, 2011 and December 31, 2010, respectively. We classified our cash and cash equivalents within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

C) Inventories. Inventories are stated at the lower of cost or net realizable value with cost being determined by the first-in, first-out ("FIFO") method. Inventory reserves are established for estimated excess and obsolete inventory. Inventories consist primarily of the following (in thousands):

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| Raw materials | $ 973 | $ 966 |
| Finished goods | 440 | 897 |

| | | |
|---|---|---|
| Total | $ 1,413 | $ 1,863 |

D) Computation of Earnings per Share. Basic earnings per share is computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing net income or loss by the weighted average number of common shares outstanding plus additional common shares that would have been outstanding if dilutive potential common shares had been issued. For the purposes of this calculation, stock options are considered common stock equivalents in periods in which they have a dilutive effect. Stock options that are anti-dilutive are excluded from the calculation.

Net income per share is calculated as follows (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net income (loss) | $(267) | $(148) | $323 | $(126) |
| Weighted average common shares outstanding | 20,700 | 19,927 | 20,461 | 19,920 |
| Additional dilutive common stock equivalents | - | - | 360 | - |
| Diluted shares outstanding | 20,700 | 19,927 | 20,821 | 19,920 |
| Net income (loss) per share – basic | $(0.01) | $(0.01) | $0.02 | $(0.01) |
| Net income (loss) per share – diluted | $(0.01) | $(0.01) | $0.02 | $(0.01) |

For the three month periods ended June 30, 2011 and 2010 potential common stock equivalents of 286,803 and 5,843, respectively, were not included in the per share calculation for diluted EPS, because we had a net loss and the effect of their inclusion would be anti-dilutive. For the six month period ended June 30, 2010 potential common stock equivalents of 7,345 were not included in the per share calculation for diluted EPS, because we had a net loss and the effect of their inclusion would be anti-dilutive.

For the three month periods ended June 30, 2011 and 2010, options to purchase 2,927,451 and 5,046,766 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive. For the six month periods ended June 30, 2011 and 2010, options to purchase 2,322,772 and 5,046,766 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

E) Stock-Based Compensation. The following table presents stock-based employee compensation expenses included in our unaudited consolidated statements of operations (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Cost of product sales | $2 | $3 | $4 | $5 |
| Cost of services | 10 | 1 | 19 | 7 |
| Research and development | 64 | 54 | 131 | 169 |
| Selling and marketing | 22 | 13 | 44 | 51 |
| General and administrative | 484 | 132 | 687 | 316 |
| Stock-based compensation expense | $582 | $203 | $885 | $548 |

Stock Option and SAR Grants. We grant stock options and stock appreciation rights ("SARs") under our 2001 Nonqualified Stock Plan. We estimate the fair value of stock options and SARs using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. The assumptions used to estimate the fair value of stock options and SARs include the expected term, the expected volatility of our stock over the expected term, the risk-free interest rate over the expected term, and our expected annual dividend yield. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options and SARs. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

Unrestricted Stock Grants. We also grant unrestricted shares of stock to directors, officers and employees under our 2001 Nonqualified Stock Plan. Stock-based compensation expense for stock grants is determined based on the fair market value of our stock on the date of grant; provided the number of shares in the grant is fixed on the grant date.

Stock Option, SAR, and Unrestricted Stock Grant Activity. The following summarizes stock-based grant activity in 2010 and 2011.

- Stock options and SARS – No stock options or SARs were granted in the three or six month periods ended June 30, 2010 and 2011.

- Unrestricted Stock Grants - In July 2010, we granted 575,443 shares of stock, including 102,040 shares to directors and 473,403 shares to officers and employees. Shares granted to directors and one employee representing a total of 111,163 shares were issued to those individuals in August 2010, which resulted in a stock-based compensation charge of $281,000 during the three months ended September 30, 2010. All other shares granted to officers and employees representing a total of 464,280 shares were scheduled to be issued in four equal increments on December 31, 2010, June 30, 2011, December 31, 2011, and June 30, 2012; provided that grantees remain employed on each of those dates. The total stock-based compensation charge associated with this grant will be amortized into expense over the related two-year service period. We amortized $100,000 and $246,000 of stock-based compensation expense related to the officer and employee portion of the grant in the three and six month periods ended June 30, 2011, respectively. Based on a June 30, 2011 employee census, the total remaining stock-based compensation charge associated with this grant over the next four quarters is expected to be approximately $401,000.

In connection with the July 2010 stock grant, we issued 115,682 shares on January 4, 2011 to officers and employees who were employed on December 31, 2010. Grantees were allowed to surrender a portion of their stock in return for the Company paying their related withholding taxes. As a result of this provision, grantees surrendered 13,721 shares of common stock and the Company paid approximately $39,000 of withholding taxes on their behalf. After the share surrender, 101,961 net shares of common stock were issued.

Our former President and CEO resigned in April 2011. As part of his separation arrangement he was granted 105,000 shares of common stock, which resulted in a stock-based compensation charge of $362,000 in the three months ended June 30, 2011. His grant contained a provision that allowed him to surrender a portion of his stock in return for the Company paying his related withholding taxes. He exercised that provision, and we issued 71,662 shares of common stock to him and paid $115,000 of withholding taxes on his behalf.

As part of the former President and CEO's separation arrangement, he forfeited: i) stock options representing 1,177,835 shares of common stock; and ii) an unrestricted stock grant that had not been issued representing 107,143 shares of common stock.

- Stock Option Exchange Program - In January 2010, we completed an employee option exchange program. Under the terms of the program, eligible rank and file employees had the right to exchange eligible vested and unvested stock options outstanding for shares of common stock. Exchange ratios for each eligible stock option were determined using the fair values of stock options and Aware's common stock immediately prior to the initiation of the program. Employees exchanged 820,481 stock options for 178,314 shares of common stock. Employees were also allowed to surrender a portion of their common stock in return for the Company paying their related withholding taxes. As a result of this provision, employees surrendered 60,659 shares of common stock and we paid approximately $161,000 of withholding taxes on their behalf. After the tax-related share surrender, 117,655 net shares of common stock were issued to participating employees.

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A portion of the 820,481 stock options that were exchanged in January 2010 were not fully vested as of the exchange date. We expensed approximately $102,000 of unamortized stock-based compensation related to such unvested stock options in the three months ended March 31, 2010.

F) Business Segments. We manage the business as one segment and conduct our operations in the United States. We sell our products and technology to domestic and international customers. Revenues were generated from the following geographic regions (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| United States | $2,969 | $2,959 | $6,614 | $6,411 |
| Germany | 583 | 799 | 942 | 1,443 |
| Rest of World | 2,361 | 1,213 | 4,716 | 2,733 |
| | $5,913 | $4,971 | $12,272 | $10,587 |

G) Income Taxes. As of December 31, 2010, we had federal net operating loss ("NOLs") and research and experimentation credit carryforwards of approximately $51.0 million and $13.5 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2011 through 2030. In addition, at December 31, 2010, we had approximately $11.3 million and $7.3 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2011 through 2025. We have recorded a full valuation allowance on all of our deferred tax assets. We will release the valuation allowance when we are able to utilize NOLs and tax credit carryforwards by offsetting future taxable income.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2010, we have not experienced a change in ownership as defined by Section 382, and, therefore, the NOLs are not currently under any Section 382 limitation.

H) Recent Accounting Pronouncements. As of the date of this report, new pronouncements issued, but not effective until after June 30, 2011, are not expected to have a material impact on our financial condition, results of operations, or disclosures.

I) Spin-off Plans. In September 2010, we announced plans to pursue a spin-off of our patent licensing operations. The spin-off would allow the spun-off entity to focus on patent licensing operations. After the spin-off, Aware would continue as a supplier of test and diagnostics products and biometrics and imaging software.

Our board is continuing to review strategic options with respect to our patent licensing operations, including a potential spin-off, but no final decision had been made.

ITEM 2:
Management’s Discussion and Analysis of
Financial Condition and Results of Operations

Cautionary Statement for Purposes of the “Safe Harbor” Provisions of the Private Securities Litigation Reform Act of 1995

Some of the information in this Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as “may,” “will,” “expect,” “anticipate,” “believe,” “estimate,” “continue” and similar words. You should read statements that contain these words carefully because they: (1) discuss our future expectations; (2) contain projections of our future operating results or financial condition; or (3) state other “forward-looking” information. However, we may not be able to predict future events accurately. The risk factors listed in our Annual Report on Form 10-K for the year ended December 31, 2010, as well as any cautionary language in this Form 10-Q, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this Form 10-Q could materially and adversely affect our business. Further, there can be no assurance as to the timing of a possible spin-off of our patent licensing operations, whether it will ultimately be structured as a spin-off, or whether the possible spin-off will be completed.

Summary of Operations. We have been a supplier of signal processing and digital communications technology for imaging and telecommunications applications since the early 1990s. Presently, our business operations are focused along three product lines: i) biometrics and imaging; ii) DSL test and diagnostics; and iii) patent licensing.

Biometrics & Imaging. Our biometrics products consist of software and services used in biometric systems, and our imaging products consist of software used primarily in medical imaging applications. Biometrics systems are used in applications such as criminal justice, border control, national defense, secure credentialing, access control and background checks. We typically sell our biometrics software and services to: i) OEMs that incorporate our products into their biometrics hardware and software systems; and ii) government agencies that are deploying biometrics systems. Our imaging software is primarily sold to OEMs that incorporate our software into their medical imaging products.

DSL Test & Diagnostics. Our test and diagnostics products consist of DSL hardware and software products that are used by telephone companies to improve the quality of their DSL service offerings. Our test and diagnostics hardware products are typically sold to OEMs that incorporate our modules into their automated testhead and handheld test equipment. Our OEM customers sell their equipment to telephone companies. We sell our test and diagnostics software products through OEMs and directly to telephone companies.

Patent Licensing. The objective of our patent licensing operations is to develop patents and to license or sell them to third parties interested in acquiring such patent rights. In September 2010, we announced plans to pursue a spin-off of our patent licensing operations. The spin-off would allow the spun-off entity to focus on patent licensing operations and for Aware to focus on being a supplier of biometrics and imaging software and DSL test and diagnostics products. There were no patent related fees in services revenue in the three and six month periods ended June 30, 2011 and 2010. As of the date of this report, our board is reviewing strategic options with respect to our patent licensing operations, including a potential spin-off.

Prior to November 2009, we were also a supplier of DSL silicon intellectual property to the semiconductor industry. We sold the assets associated with that product line in November 2009, consequently silicon IP development and licensing is no longer a material part of our business. We continue to receive royalties from two customers that use our DSL silicon IP in their DSL chipsets, including the company that purchased our DSL silicon IP product line.

Summary of Financial Results. Our net loss for the three months ended June 30, 2011 was $267,000, or $0.01 per share, which compares to a net loss of $148,000, or $0.01 per share, for the three months ended June 30, 2010.

Net income for the six months ended June 30, 2011 was $323,000, or $0.02 per share, which compares to a net loss of $126,000, or $0.01 per share, for the six months ended June 30, 2010.

Results of Operations

Product Sales. Product sales consist primarily of revenue from the sale of hardware and software products. Hardware products consist primarily of DSL test and diagnostics modules. Software products consist of software products, including maintenance contracts, for biometrics, medical imaging, and DSL test and diagnostics applications.

Product sales increased 2% from $3.9 million in the second quarter of 2010 to $4.0 million in the current year quarter. As a percentage of total revenue, product sales decreased from 79% in the second quarter of 2010 to 68% in the current year quarter. The dollar increase in product sales was primarily due to a $0.4 million increase in revenue from the sale of test and diagnostic hardware and software, which was partially offset by a $0.3 million decrease in revenue from the sale of biometrics software. The $0.4 million increase in revenue from the sale of test and diagnostic products was mainly attributable to: 1) a $0.3 million increase in hardware revenue; and 2) a $0.1 million increase in software revenue. The $0.3 million decrease in revenue from the sale of biometrics software was primarily due to lower customer demand for these products in the current quarter.

For the six months ended June 30, 2011, product sales increased 6% from $8.6 million in 2010 to $9.1 million in 2011. As a percentage of total revenue, product sales decreased from 81% in the first six months of 2010 to 74% in the corresponding period of 2011. The dollar increase in product sales was primarily due to a $1.1 million increase in revenue from the sale of test and diagnostic hardware and software, which was partially offset by a $0.6 million decrease in revenue from the sale of biometrics software. The $1.1 million increase in revenue from the sale of test and diagnostic products was mainly attributable to: 1) a $0.7 million increase in software revenue as a result of the sale of our LDP software to a European telephone company; and 2) a $0.4 million increase in hardware revenue. The $0.6 million decrease in revenue from the sale of biometrics software was primarily due to lower customer demand for these products in the current six month period.

Services. Services, which we previously called "Contract Revenue," primarily consist of engineering service fees related to: i) our biometrics and imaging product line; ii) our DSL test and diagnostics product line; and iii) a legacy DSL silicon contract.

Services increased 298% from $0.3 million in the second quarter of 2010 to $1.4 million in the current year quarter. As a percentage of total revenue, services increased from 7% in the second quarter of 2010 to 23% in the current year quarter.

For the six months ended June 30, 2011, services increased 297% from $0.6 million in 2010 to $2.2 million in 2011. As a percentage of total revenue, services increased from 5% in the first six months of 2010 to 18% in the corresponding period of 2011.

For the three and six month periods, the dollar increase in services was primarily due to increases in revenue from the sale of biometrics engineering services. One of our strategic objectives over the last few years has been to increase revenue from biometrics engineering projects. Services revenue results in the current three and six month periods reflect initial success towards that goal. However, we are unable to predict whether services revenue will trend upward or downward in future periods as we continue to develop this business.

Royalties. Royalties consist of royalty payments we receive under legacy DSL silicon contracts. We receive royalties from DSL silicon customers for the right to incorporate our silicon IP in their DSL chipsets.

Royalties decreased 24% from $0.7 million in the second quarter of 2010 to $0.5 million in the current year quarter. As a percentage of total revenue, royalties decreased from 14% in the second quarter of 2010 to 9% in the current year quarter.

For the six months ended June 30, 2011, royalties decreased 33% from $1.5 million in 2010 to $1.0 million in 2011. As a percentage of total revenue, royalties decreased from 14% in the first six months of 2010 to 8% in the corresponding period of 2011.

For the three and six month periods, the dollar decrease in royalties was primarily due to lower DSL royalties reported to us by one of our licensees.

Our royalty revenue currently comes predominantly from DSL chipset sales by Ikanos Communications, Inc. (“Ikanos”) and Lantiq Deutschland GmbH (“Lantiq”). The sale of our DSL silicon IP assets in November 2009 did not alter the royalty obligations of Ikanos or Lantiq, which we expect to continue per the existing agreements with those parties. We remain uncertain as to whether these licensees will be able to maintain their market shares and chipset prices in the face of intense competition, and whether our relationships with them will contribute meaningful royalties to us in the future. Accordingly, we are unable to predict whether royalties reported by our licensees will trend upward or downward in future periods.

Cost of Product Sales. Since the cost of software product sales is minimal, cost of product sales consists primarily of the cost of hardware product sales.

Cost of product sales increased 29% from $0.8 million in the second quarter of 2010 to $1.1 million in the current year quarter. As a percentage of product sales, cost of product sales increased from 21% in the second quarter of 2010 to 27% in the current year quarter, which means that product gross margins decreased from 79% to 73%. The cost of product sales dollar increase of $0.3 million was primarily due to: 1) $0.2 million of higher product costs driven by a $0.4 million increase in revenue from hardware product sales; and 2) $0.1 million of higher manufacturing period costs. Product gross margins decreased from 79% to 73% primarily due to a greater proportion of hardware in the product sales mix in the current year quarter.

For the six months ended June 30, 2011, cost of product sales increased 23% from $1.9 million in 2010 to $2.3 million in 2011. As a percentage of product sales, cost of product sales increased from 22% in the first six months of 2010 to 25% in the corresponding period of 2011, which means that product gross margins decreased from 78% to 75%. The cost of product sales dollar increase of $0.4 million was primarily due to: 1) $0.3 million of higher product costs driven by a $0.4 million increase in revenue from hardware product sales; and 2) $0.1 million of higher manufacturing period costs. Product gross margins decreased from 78% to 75% primarily due to a greater proportion of hardware in the product sales mix in the current six month period.

Cost of Services. Cost of services, which we previously called "Cost of Contract Revenue," consists of engineering costs to complete customer engineering projects. Such costs primarily include: i) engineering salaries, stock-based compensation, fringe benefits, and facilities; and ii) engineering consultants and contractors.

Cost of services increased 511% from $74,000 in the second quarter of 2010 to $450,000 in the current year quarter. Cost of services as a percentage of services increased from 21% in the second quarter of 2010 to 33% in the current quarter, which means that gross margins on services decreased from 79% to 67%.

For the six months ended June 30, 2011, cost of services increased 455% from $145,000 in the first six months of 2010 to $807,000 in the corresponding period of 2011. Cost of services as a percentage of services increased from 26% in the first six months of 2010 to 37% in the corresponding period of 2011, which means that gross margins on services decreased from 74% to 63%.

For the three and six month periods, the dollar increase in cost of services was primarily due to an increase in biometrics engineering services as described in the Services section above. The decrease in gross margins on services was primarily due to the composition of engineering services projects. In the current year periods, we worked on larger-sized projects that were less profitable than the smaller-sized projects we were engaged in last year.

Research and Development Expense. Research and development expense consists of costs for: i) engineering personnel, including salaries, stock-based compensation, fringe benefits, and facilities; ii) engineering consultants and contractors, and iii) other engineering expenses such as supplies, equipment depreciation, dues and memberships and travel. Engineering costs are incurred to develop technology, products and patents related to our various product lines. As described in the cost of services section, engineering costs incurred to provide engineering services for customer projects are classified as cost of services, and are not included in research and development expense.

Research and development expense decreased 13% from $2.1 million in the second quarter of 2010 to $1.8 million in the current year quarter. As a percentage of total revenue, research and development expense decreased from 42% in the second quarter of 2010 to 31% in the current year quarter. The dollar decrease in research and development expense was the result of two sets of factors, one of which partially offset the other. Total engineering expenses increased by $0.1 million in the current quarter primarily due to headcount additions and the engagement of engineering contractors. However, due to the increased level of services revenue for customer engineering projects, we classified $0.4 million more engineering costs to cost of services this quarter. The net result is the research and development expense declined by approximately $0.3 million in the current three month period.

Research and development expense decreased 8% from $4.1 million in the first six months of 2010 to $3.8 million in the first six months of 2011. As a percentage of total revenue, research and development expense decreased from 39% in the first six months of 2010 to 31% in the corresponding period of 2011. Similar to the three month periods, the dollar decrease in research and development expense in the six month periods was the result of two sets of offsetting factors. Total engineering expenses increased by $0.3 million in the current six month period primarily due to headcount additions and the engagement of engineering contractors. However, due to the increased level of services revenue for customer engineering projects, we classified $0.6 million more engineering costs to cost of services. The net result is the research and development expense declined by approximately $0.3 million in the current six month period.

Our research and development activities are focused primarily on developing: i) biometrics and imaging software; and ii) test and diagnostics hardware and software.

Selling and Marketing Expense. Selling and marketing expense primarily consists of costs for: i) sales and marketing personnel, including salaries, sales commissions, stock-based compensation, fringe benefits, travel, and facilities; and ii) advertising and promotion expenses.

Sales and marketing expense was $1.1 million for the three months ended June 30, 2010 and 2011. As a percentage of total revenue, sales and marketing expense decreased from 21% in the second quarter of 2010 to 18% in the corresponding period of 2011.

For the six months ended June 30, 2011 and 2010, sales and marketing expense was $2.1 million. As a percentage of total revenue, sales and marketing expense decreased from 20% in the first six months of 2010 to 17% in the corresponding period of 2011.

For the three and six month periods, unchanged sales and marketing expense reflected: 1) a stable sales and marketing organization; and 2) consistent levels of promotional activities.

General and Administrative Expense. General and administrative expense consists primarily of costs for: i) officers, directors and administrative personnel, including salaries, bonuses, director compensation, stock-based compensation, fringe benefits, and facilities; ii) professional fees, including legal and audit fees; iii) public company expenses; and iv) other administrative expenses, such as insurance costs and bad debt provisions.

General and administrative expense increased 26% from $1.4 million in the second quarter of 2010 to $1.8 million in the current year quarter. As a percentage of total revenue, general and administrative expense increased from 28% in the second quarter of 2010 to 30% in the current year quarter.

For the six months ended June 30, 2011, general and administrative expense increased 6% from $2.8 million in 2010 to $3.0 million in 2011. As a percentage of total revenue, general and administrative expense decreased from 27% in the first six months of 2010 to 24% in the corresponding period of 2011.

For the three and six month periods, the dollar increase in general and administrative expense was primarily due to $0.6 million of severance related expenses that were incurred upon the resignation of our former President and CEO in April 2011. Severance related expenses were partially offset by lower legal fees and compensation expenses for directors and officers.

Other Income. Other income was $325,000 in the second quarter of 2010. This amount represents proceeds from a legal settlement with a former customer.

Interest Income. Interest income decreased 27% from $21,000 in the second quarter of 2010 to $16,000 in the current year quarter.

For the six months ended June 30, 2011, interest income decreased 11%, from $39,000 in 2010 to $35,000 in 2011.

For the three and six month periods, the dollar decrease was primarily due to a decline in money market interest rates.

Income Taxes. We made no provision for income taxes in the six months ended June 30, 2011 and 2010, except for $2,000 and $1,000 of state excise taxes on our interest income, respectively. We recorded no provision for income taxes despite net income in 2011, because we will be able to offset any annual net income with our NOL and tax credit carryforwards.

As of December 31, 2010, we had federal NOLs and research and experimentation credit carryforwards of approximately $51.0 million and $13.5 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2011 through 2030. In addition, at December 31, 2010, we had approximately $11.3 million and $7.3 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2011 through 2025.

Due to the uncertainty surrounding the realization of our deferred tax assets, based principally on our historical operating losses, we have provided a full valuation allowance against our various tax attributes. We will assess the level of valuation allowance required in future periods. Should more positive than negative evidence regarding the realizability of tax attributes exist at a future point in time, the valuation allowance may be reduced or eliminated altogether. Reduction of the valuation allowance, in whole or in part, would result in a non-cash reduction in income tax expense during the period of reduction.

Liquidity and Capital Resources

At June 30, 2011, we had cash and cash equivalents of $43.2 million, which represented an increase of $3.3 million from December 31, 2010. The increase in cash was primarily due to: i) $1.8 million of cash provided by operations; and ii) $1.7 million of proceeds from the issuance of common stock as a result of stock option exercises. Increases in cash from these sources were partially offset by: i) $88,000 of cash used to purchase capital equipment; and ii) $154,000 of cash used to pay withholding taxes for employees who surrendered shares of common stock in connection stock issuances.

We generated $1.8 million of cash from operations in the first six months of 2011. Cash provided by operations was primarily driven by net income of $0.3 million, which was further increased by: i) non-cash adjustments of $0.2 million for depreciation and amortization and $0.9 million for stock-based compensation expense; and ii) a $0.4 million reduction of working capital.

Capital spending was primarily related to the purchase of computer hardware and laboratory equipment used principally in engineering activities.

We issued stock in connection with several officer and employee stock grants during 2011. We allowed grantees to surrender a portion of their shares of stock in return for the Company paying their related withholding taxes. As a result of this provision, grantees surrendered 47,059 shares of common stock, and we paid approximately $154,000 of withholding taxes on their behalf.

While we cannot assure you that we will not require additional financing, or that such financing will be available to us, we believe that our cash and cash equivalents will be sufficient to fund our operations for at least the next twelve months.

Recent Accounting Pronouncements

See Note H to our Consolidated Financial Statements in Item 1.

ITEM 3:
Quantitative and Qualitative Disclosures about Market Risk

Our exposure to market risk relates primarily to our investment portfolio, and the effect that changes in interest rates would have on that portfolio. Our investment portfolio has included:

- Cash and cash equivalents, which consist of financial instruments with original maturities of three months or less;
- Short-term investments, which consist of financial instruments with remaining maturities of twelve months or less; and
  - Investments, which consist of financial instruments that mature in three years or less.

All of our investments meet the high quality standards specified in our investment policy. This policy dictates the maturity period and limits the amount of credit exposure to any one issue, issuer, and type of instrument.

As of June 30, 2011, our cash and cash equivalents of $43.2 million were invested in money market accounts. Due to the nature and short duration of these financial instruments, we do not expect that an increase in interest rates would result in any material loss to our investment portfolio. As of June 30, 2011, we had no investments that matured in more than twelve months. We do not use derivative financial instruments for speculative or trading purposes.

ITEM 4:
Controls and Procedures

Our management, including our co-chief executive officers and chief financial officer, has evaluated our disclosure controls and procedures as of the end of the quarterly period covered by this Form 10-Q and has concluded that our disclosure controls and procedures are effective. They also concluded that there were no changes in our internal control over financial reporting that occurred during the quarterly period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1:
### Legal Proceedings

From time to time we are involved in litigation incidental to the conduct of our business. We are not party to any lawsuit or proceeding that, in our opinion, is likely to seriously harm our business.

### ITEM 1A:
### Risk Factors

The risks described in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2010, could materially and adversely affect our business, financial condition and results of operations. The risk factors discussed in that Form 10-K do not identify all risks that we face because our business operations could also be affected by additional factors that are not presently known to us or that we currently consider to be immaterial to our operations. No material change in the risk factors discussed in that Form 10-K has occurred.

ITEM 6:
Exhibits

(a) Exhibits

| | |
|---|---|
| Exhibit 10.1* | Separation Agreement dated April 1, 2011 between Aware, Inc. and Edmund C. Reiter (filed as Exhibit 10.1 to the Company's Form 8-K filed with the Securities and Exchange Commission on April 1, 2011 and incorporated herein by reference). |
| Exhibit 10.2* | Consulting Agreement dated April 1, 2011 between Aware, Inc. and Edmund C. Reiter (filed as Exhibit 10.2 to the Company's Form 8-K filed with the Securities and Exchange Commission on April 1, 2011 and incorporated herein by reference). |
| Exhibit 31.1 | Certification of co-Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 31.2 | Certification of co-Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

*Management contract or compensatory plan.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AWARE, INC.

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|---|---|---|
| Date: July 27, 2011 | By: | /s/ Kevin T. Russell<br>Kevin T. Russell<br>co-Chief Executive Officer &<br>co-President<br>General Counsel |
| Date: July 27, 2011 | By: | /s/ Richard P. Moberg |

Richard P. Moberg,
co-Chief Executive Officer &
co-President
Chief Financial Officer (Principal
Financial and Accounting Officer)