AWARE INC /MA/
Form 10-Q
July 28, 2010

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, 2010

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 26, 2010:

Class	Number of Shares Outstanding
Common Stock, par value $0.01 per share	19,927,982 shares

AWARE, INC.

FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2010

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

	June 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$39,129	$39,669
Accounts receivable, net	4,533	3,565
Inventories	1,334	1,113
Prepaid expenses and other current assets	333	363
Total current assets	45,329	44,710
Property and equipment, net	6,555	6,744
Other assets, net	33	-
Total assets	$51,917	$51,454
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$642	$327
Accrued expenses	75	127
Accrued compensation	1,020	1,202
Accrued professional	309	282
Deferred revenue	712	563
Total current liabilities	2,758	2,501
Long-term deferred revenue	536	593
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 19,927,982 as of June 30, 2010 and 19,809,315 as of December 31, 2009	199	198
Additional paid-in capital	76,420	76,032
Accumulated deficit	(27,996)	(27,870)
Total stockholders' equity	48,623	48,360
Total liabilities and stockholders' equity	$51,917	$51,454

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

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

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenue:				
Product sales	$3,911	$3,852	$8,562	$6,671
Contract revenue	346	1,442	555	2,719
Royalties	714	470	1,470	947
Total revenue	4,971	5,764	10,587	10,337
Costs and expenses:				
Cost of product sales	840	1,043	1,877	1,556
Cost of contract revenue	74	909	145	1,817
Research and development	2,082	3,058	4,117	6,170
Selling and marketing	1,053	1,184	2,119	2,265
General and administrative	1,416	1,216	2,818	2,429
Total costs and expenses	5,465	7,410	11,076	14,237
Loss from operations	(494)	(1,646)	(489)	(3,900)
Other income	325	-	325	-
Interest income	21	61	39	186
Loss before provision for income taxes	(148)	(1,585)	(125)	(3,714)
Provision for income taxes	-	1	1	4
Net loss	$(148)	$(1,586)	$(126)	$(3,718)
Net loss per share – basic	$(0.01)	$(0.08)	$(0.01)	$(0.17)
Net loss per share – diluted	$(0.01)	$(0.08)	$(0.01)	$(0.17)
Weighted average shares – basic	19,927	20,666	19,920	21,974
Weighted average shares - diluted	19,927	20,666	19,920	21,974

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, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net loss	$(126)	$(3,718)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	260	448
Stock based compensation	548	800
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	(968)	(2,424)
Inventories	(220)	528
Prepaid expenses	30	(241)
Accounts payable	337	69
Accrued expenses	(107)	(285)
Deferred revenue	92	230
Net cash used in operating activities	(154)	(4,593)
Cash flows from investing activities:		
Purchases of property and equipment	(67)	(116)
Expenses from sale of assets	(100)	-
Purchases of other assets	(60)	-
Net cash used in investing activities	(227)	(116)
Cash flows from financing activities:		
Proceeds from issuance of common stock	2	3
Shares surrendered by employees to pay taxes related to unrestricted stock	(161)	-
Repurchase of common stock	-	(8,950)
Net cash used in financing activities	(159)	(8,947)
Decrease in cash and cash equivalents	(540)	(13,656)
Cash and cash equivalents, beginning of period	39,669	45,516
Cash and cash equivalents, end of period	$39,129	$31,860

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

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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, 2010, and of operations and cash flows for the interim periods ended June 30, 2010 and 2009.

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, 2009 in conjunction with our 2009 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, 2010 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 in September 2006, which defines fair value, establishes a framework for measuring fair value, and expands disclosures assets and liabilities measured at fair value in financial statements. This guidance is set forth in FASB Accounting Standards Codification 820 (ASC 820). We adopted the provisions of ASC 820 as of January 1, 2008, for our financial instruments. Although the adoption of ASC 820 did not materially impact our financial condition, results of operations, or cash flow, we are now required to provide additional disclosures as part of our financial statements.

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, 2010 or December 31, 2009.

Our cash and cash equivalents, including money market securities, were $39.1 million and $39.7 million as of June 30, 2010 and December 31, 2009, 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, 2010	December 31, 2009
Raw materials	$ 1,334	$ 1,112
Finished goods	-	1
Total	$ 1,334	$ 1,113

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2009	2009
Net loss	$ (148)	$ (1,586)	$(126)	$ (3,718)
Weighted average common shares outstanding	19,927	20,666	19,920	21,974
Additional dilutive common stock equivalents	-	-	-	-
Diluted shares outstanding	19,927	20,666	19,920	21,974
Net loss per share – basic and diluted	$ (0.01)	$ (0.08)	$(0.01)	$ (0.17)

For the three month periods ended June 30, 2010 and 2009 potential common stock equivalents of 5,843 and 6,986, 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 and 2009 potential common stock equivalents of 7,345 and 3,377, respectively, were not included in the per share calculation for diluted EPS, because we had net losses and the effect of their inclusion would be anti-dilutive.

For the three month periods ended June 30, 2010 and 2009, options to purchase 5,046,766 and 7,564,743 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, 2010 and 2009, options to purchase 5,046,766 and 7,564,743 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.

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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,	
	2010	2009	2010	2009
Cost of product sales	$3	$3	$5	$5
Cost of contract revenue	1	36	7	68
Research and development	54	138	169	285
Selling and marketing	13	57	51	109
General and administrative	132	175	316	333
Stock-based compensation expense	$203	$409	$548	$800

We estimate the fair value of stock options 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. These assumptions used to estimate the fair value of stock options 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. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company's stock options granted in the three and six month periods ended June 30, 2009. No options were granted in the three and six month periods ended June 30, 2010. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

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.

When the program ended on January 12, 2010, eligible employees had exchanged 820,481 stock options for 178,314 shares of common stock. Participating employees were allowed to surrender a portion of their common stock in return for the Company paying withholding taxes related to their stock grants. As a result of this provision, employees surrendered 60,659 shares of common stock and the Company paid approximately $161,000 of withholding taxes on their behalf. After the common stock share surrender, 117,655 net shares of common stock were issued to participating employees.

A portion of the 820,481 stock options that were exchanged 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 six months ended June 30, 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,	
	2010	2009	2010	2009
United States	$2,959	$3,578	$6,411	$6,103
Germany	799	1,534	1,443	2,568
Rest of World	1,213	652	2,733	1,666
	$4,971	$5,764	$10,587	$10,337

G) Income Taxes

As of December 31, 2009, we had federal net operating loss ("NOLs") and research and experimentation credit carryforwards of approximately $47.6 million and $13.4 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2010 through 2029. In addition, at December 31, 2009, we had approximately $10.3 million and $7.1 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2010 through 2024.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2009, 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

We describe below recent pronouncements that have had or may have a significant effect on our financial statements. We do not discuss recent pronouncements that are not anticipated to have an impact on or are unrelated to our financial condition, results of operations, or disclosures.

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2010-06, "Improving Disclosures about Fair Value Measurements". ASU 2010-06 requires additional disclosures about fair value measurements including transfers in and out of Levels 1 and 2 and a higher level of disaggregation for the different types of financial instruments. For the reconciliation of Level 3 fair value measurements, information about purchases, sales, issuances and settlements are presented separately. This standard is effective for interim and annual reporting periods beginning after December 15, 2009 with the exception of revised Level 3 disclosure requirements which are effective for interim and annual reporting periods beginning after December 15, 2010. Comparative disclosures are not required in the year of adoption. We adopted the provisions of the standard on January 1, 2010, which did not have a material impact on our financial statements.

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I) Share Repurchase Program

On March 5, 2009, we announced a modified Dutch auction self-tender offer to purchase up to 3,500,000 shares, or approximately 15%, of our outstanding common stock (including the associated preferred share purchase rights), at a price in the range of $2.20 to $2.60 per share, for a maximum aggregate purchase price of approximately $9.1 million. The terms of the tender offer also provided the right for us to purchase up to an additional 2% of our shares if the offer was oversubscribed.

The tender offer closed on April 17, 2009, and on April 23, 2009 we repurchased 3,500,252 shares at $2.50 per share for a total cost of $9.0 million, including expenses.

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, 2009, 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.

Summary. We have historically organized ourselves as one segment with three product lines. Our product lines have included: i) DSL test and diagnostics products, ii) biometrics products, and iii) licensing products.

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 products are typically sold to OEMs that incorporate our products into their products. Our OEM customers sell their equipment and software products to telephone companies. We also market our test and diagnostics software directly to telephone companies.

Our biometrics products consist of software and services used in biometric systems. Biometric systems are used by governments and enterprises to verify the identification of people. Biometrics systems are used in applications such as border control, secure credentialing, and background checks. We typically sell our biometrics software and services to OEMs and system integrators that incorporate our products into their biometrics hardware and software systems. We also sell a modest amount of medical imaging software that is included in our biometrics product line revenue.

Our licensing products have consisted of: i) DSL technology products, ii) home networking technology products, and iii) patents related to DSL, home networking and other technologies. Our technology products have been licensed to semiconductor companies that sell chipsets that incorporate our technology. Our patents are sold or licensed to third parties interested in acquiring such patent rights.

On November 13, 2009, we completed a transaction in which we sold substantially all of the assets associated with our licensing product line to Lantiq Deutschland GmbH ("Lantiq") for $6.75 million. Lantiq is a fabless semiconductor company that was spun out of Infineon Technologies AG ("Infineon"), our largest DSL licensing customer at that time. The sale included: i) our DSL and home networking technology assets; ii) certain patents and patent applications related to those technology assets; iii) a group of 41 engineers; and iv) lab and computer equipment used by the transferred engineers.

As a result of the Lantiq transaction, we will no longer derive DSL contract revenue from Infineon or Lantiq. Over the past several years, contract revenue from Infineon has ranged from $0.5 million to $1.0 million per quarter. We amended and restated the existing license agreement between us and Infineon to provide Lantiq (as successor to Infineon) certain non-exclusive licenses of our patent rights, and to continue Lantiq's royalty obligations to Aware. We also expect to continue to derive contract revenue for engineering support and royalties per our existing agreements with Ikanos Communications, Inc. ("Ikanos"). We will not be pursuing new silicon intellectual property licensing customers for DSL or home networking applications for the foreseeable future. In addition, Aware subleased certain office and lab space to Lantiq at its main facilities in Bedford, Massachusetts. In the first and second quarters of 2010, engineering expenses associated with our licensing product line decreased by approximately $1.9 million per quarter, compared to the corresponding periods in 2009 as a result of the transfer of 41 engineers to Lantiq. We expect that quarterly engineering expenses in the third quarter of 2010 will decrease by $1.7 million to $2.0 million compared to the corresponding period in 2009 as a result of the employee transfer.

After the sale of our licensing product line to Lantiq in November 2009, we have operated as one segment with two principal product lines: i) biometrics products; and ii) DSL test and diagnostics products. We expect that the Lantiq transaction will have a minimal impact on the future financial results of our biometrics and DSL test and diagnostics product lines. As it relates to our DSL test business, Aware and Lantiq will cooperate with one another with respect to embedded wireline diagnostics technology and products.

Our net loss in accordance with generally accepted accounting principles ("GAAP") for the three months ended June 30, 2010 was $148,000, or minus $0.01 per share, which compares to a GAAP net loss of $1.6 million, or minus $0.08 per share, for the three months ended June 30, 2009. Our GAAP net loss for the six months ended June 30, 2010 was $126,000, or minus $0.01 per share, which compares to a GAAP net loss of $3.7 million, or minus $0.17 per share, for the six months ended June 30, 2009.

Readers of this report should keep in mind that our financial results for the three and six month periods ended June 30, 2009 included the revenue and expense impact of the licensing product line that was sold to Lantiq in November 2009, whereas results for the three and six month periods ended June 30, 2010 no longer included such revenue and expenses. The royalty obligations of Lantiq and Ikanos were not affected by the Lantiq transaction and therefore royalty revenue is included in all three and six month periods ended June 30, 2010 and 2009.

The Company uses non-GAAP information internally to evaluate its operating performance and believes these non-GAAP measures are useful to investors as they provide additional insight into the underlying operating results. Our non-GAAP net income (loss) excludes the effect of stock-based compensation expense.

Non-GAAP net income for the three months ended June 30, 2010, excluding the effect of $203,000 of stock-based compensation, was $55,000, or $0.00 per diluted share. We had a non-GAAP net loss for the three months ended June 30, 2009, excluding the effect of $409,000 of stock-based compensation, of $1.2 million, or minus $0.06 per diluted share.

Non-GAAP net income for the six months ended June 30, 2010, excluding the effect of $548,000 of stock-based compensation, was $422,000, or $0.02 per diluted share. We had a non-GAAP net loss for the six months ended June 30, 2009, excluding the effect of $800,000 of stock-based compensation, of $2.9 million, or minus $0.13 per diluted share.

A reconciliation of GAAP to non-GAAP results is set forth in the table below (in thousands, except for per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
GAAP net loss	$(148)	$(1,586)	$(126)	$(3,718)
Stock-based compensation	203	409	548	800
Non-GAAP net income (loss)	$55	$(1,177)	$422	$(2,918)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
GAAP net loss per share	$(0.01)	$(0.08)	$(0.01)	$(0.17)
Stock-based compensation	0.01	0.02	0.03	0.04
Non-GAAP net income (loss) per share	$0.00	$(0.06)	$0.02	$(0.13)

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 biometric, medical imaging and digital imaging applications, as well as DSL test and diagnostics software.