AWARE INC /MA/
Form 10-Q
July 31, 2009

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, 2009

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 27, 2009:

Class	Number of Shares Outstanding
Common Stock, par value $0.01 per share	19,782,128 shares

AWARE, INC.

FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2009

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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, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 31,860	$ 45,516
Accounts receivable, net	4,635	2,211
Inventories	1,128	1,656
Prepaid expenses and other current assets	839	598
Total current assets	38,462	49,981
Property and equipment, net	7,165	7,463
Other assets, net	68	102
Total assets	$ 45,695	$ 57,546
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 535	$ 466
Accrued expenses	129	241
Accrued compensation	1,276	1,480
Accrued professional	198	167
Deferred revenue	569	339
Total current liabilities	2,707	2,693
Long-term deferred revenue	330	330
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 19,782,128 as of June 30, 2009 and 23,281,204 as of December 31, 2008	198	233
Additional paid-in capital	75,030	83,143
Accumulated deficit	(32,570)	(28,853)
Total stockholders' equity	42,658	54,523
Total liabilities and stockholders' equity	$ 45,695	$ 57,546

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, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Revenue:				
Product sales	$ 3,852	$ 3,948	$ 6,671	$ 7,872
Contract revenue	1,442	1,776	2,719	3,298
Royalties	470	443	947	874
Total revenue	5,764	6,167	10,337	12,044
Costs and expenses:				
Cost of product sales	1,043	624	1,556	1,448
Cost of contract revenue	909	1,129	1,817	2,148
Research and development	3,058	3,511	6,170	7,039
Selling and marketing	1,184	1,186	2,265	2,155
General and administrative	1,216	1,285	2,429	2,478
Total costs and expenses	7,410	7,735	14,237	15,268
Loss from operations	(1,646)	(1,568)	(3,900)	(3,224)
Interest income	61	315	186	698
Loss before provision for income taxes	(1,585)	(1,253)	(3,714)	(2,526)
Provision for income taxes	1	4	4	13
Net loss	$ (1,586)	$ (1,257)	$ (3,718)	$ (2,539)
Net loss per share – basic	$ (0.08)	$ (0.05)	$ (0.17)	$ (0.11)
Net loss per share – diluted	$ (0.08)	$ (0.05)	$ (0.17)	$ (0.11)
Weighted average shares – basic	20,666	23,869	21,974	23,875
Weighted average shares - diluted	20,666	23,869	21,974	23,875

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, 2009	Six Months Ended June 30, 2008
Cash flows from operating activities:		
Net loss	$ (3,718)	$ (2,539)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	448	457
Stock based compensation	800	718
Provision for doubtful accounts	-	(19)
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	(2,424)	1,986
Inventories	528	(646)
Prepaid expenses	(241)	135
Accounts payable	69	15
Accrued expenses	(285)	22
Deferred revenue	230	(94)
Net cash provided by (used in) operating activities	(4,593)	35
Cash flows from investing activities:		
Purchases of property and equipment	(116)	(274)
Sales of investments	-	38,743
Purchases of investments	-	(2,000)
Net cash provided by (used in) investing activities	(116)	36,469
Cash flows from financing activities:		
Proceeds from issuance of common stock	3	337
Repurchase of common stock	(8,950)	(782)
Net cash used in financing activities	(8,947)	(445)
Increase (decrease) in cash and cash equivalents	(13,656)	36,059
Cash and cash equivalents, beginning of period	45,516	1,806
Cash and cash equivalents, end of period	$ 31,860	$ 37,865

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, 2009, and of operations and cash flows for the interim periods ended June 30, 2009 and 2008. Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

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 footnotes 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 footnotes necessary for such presentation for the three years ended December 31, 2008 in conjunction with our 2008 Annual Report on Form 10-K.

The results of operations for the interim period ended June 30, 2009 are not necessarily indicative of the results to be expected for the year. We evaluated subsequent events through July 31, 2009, the date of financial statement issuance.

B) Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157 ("SFAS 157"), "Fair Value Measurements". SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. We adopted the provisions of SFAS 157 as of January 1, 2008, for our financial instruments. Although the adoption of SFAS 157 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.

SFAS 157 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, 2009 or December 31, 2008.

Our cash and cash equivalents, including money market securities, were $31.9 million and $45.5 million as of June 30, 2009 and December 31, 2008, 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) Inventory

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. Inventory consists primarily of the following (in thousands):

	June 30, 2009	December 31, 2008
Raw materials	$ 1,127	$ 1,650
Finished goods	1	6
Total	$ 1,128	$ 1,656

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,	
	2009	2008	2009	2008
Net loss	$ (1,586)	$ (1,257)	$ (3,718)	$ (2,539)
Weighted average common shares outstanding	20,666	23,869	21,974	23,875
Additional dilutive common stock equivalents	-	-	-	-
Diluted shares outstanding	20,666	23,869	21,974	23,875
Net loss per share – basic and diluted	$ (0.08)	$ (0.05)	$ (0.17)	$ (0.11)

For the three month periods ended June 30, 2009 and 2008 potential common stock equivalents of 6,986 and 238,039, 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, 2009 and 2008 potential common stock equivalents of 3,377 and 448,568, 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, 2009 and 2008, options to purchase 7,564,743 and 4,455,998 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, 2009 and 2008, options to purchase 7,564,743 and 3,932,798 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 the Company's unaudited consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Cost of product sales	$ 3	$ 3	$ 5	$ 6
Cost of contract revenue	36	26	68	60
Research and development	138	160	285	327
Selling and marketing	57	50	109	81
General and administrative	175	154	333	244
Stock-based compensation expense	$ 409	$ 393	$ 800	$ 718

The Company estimates 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 the Company's stock over the expected term, the risk-free interest rate over the expected term, and the Company's 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 months ended June 30, 2009 and June 30, 2008. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

F) Business Segments

The Company organizes itself as one segment and conducts its operations in the United States.

The Company sells its 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,	
	2009	2008	2009	2008
United States	$ 3,578	$ 4,897	$ 6,103	$ 8,898
Germany	1,534	856	2,568	2,371
Rest of World	652	414	1,666	775
	$ 5,764	$ 6,167	$ 10,337	$ 12,044

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G) Income Taxes

As of December 31, 2008, we had federal net operating loss and research and experimentation credit carryforwards of approximately $46.5 million and $12.8 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2009 through 2029. In addition, at December 31, 2008, we had approximately $11.4 million and $6.6 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2009 through 2023.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2007, 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

In May 2009, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 165, "Subsequent Events," which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. SFAS No. 165 provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The Company adopted SFAS No. 165 during the second quarter of 2009, and its application had no impact on the Company's consolidated financial statements.

In June 2009, the FASB issued Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles. Statement No. 168 replaces FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles, and establishes the FASB Accounting Standards Codification TM (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). Statement No. 168 is effective for interim and annual periods ending after September 15, 2009. The Company will begin to use the new Codification when referring to GAAP in its quarterly report on Form 10-Q for the fiscal period ending September 30, 2009. This will not have an impact on the consolidated results of the Company.

In September 2006, the FASB issued SFAS No. 157 ("SFAS 157"), "Fair Value Measurements," which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on February 6, 2008, the FASB issued FSP FAS 157-b which defers the effective date of SFAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. We adopted SFAS 157 on January 1, 2008, except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-b. We adopted FSP FAS 157-b on January 1, 2009. The adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard ("SFAS") No. 160, “Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51.” SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This accounting standard is effective for fiscal years beginning after December 15, 2008. We adopted SFAS 160 on January 1, 2009. The adoption of SFAS 160 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard ("SFAS") No. 141(R), “Business Combinations.” SFAS 141(R) establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, an any noncontrolling interest in the acquiree, recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This accounting standard is effective for fiscal years beginning after December 15, 2008. We adopted SFAS 141(R) on January 1, 2009. The adoption of SFAS 141(R) did not have a material impact on our consolidated financial position, results of operations or cash flows as of the date of adoption. SFAS 141(R) will be applied to any future business combinations.

I) Share Repurchase Program

On August 28, 2007, we announced a stock repurchase program to purchase up to $5.0 million of our common stock, subject to market conditions and other factors. Any purchases under our stock repurchase program may be made from time to time without prior notice. On October 29, 2008, we announced that the program had been amended to increase the total amount of common stock that may be repurchased from $5.0 million to $10.0 million and to extend the period of time that shares may be repurchased from December 31, 2008 to December 31, 2009. As of June 30, 2009, we had repurchased 721,131 shares of common stock at a total cost of $2.4 million under this program. We did not repurchase any shares during the three and six month periods ended June 30, 2009.

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 this Form 10-Q, 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.

Results of Operations

Product Sales. Product sales consist primarily of revenue from the sale of hardware and software products. Hardware products consist of DSL test and diagnostics hardware, including systems, modules, and modems. Software products consist of software products for biometric, medical imaging and digital imaging applications, as well as DSL test and diagnostics software.

Product sales decreased 2% from $3.95 million in the second quarter of 2008 to $3.85 million in the current year quarter. As a percentage of total revenue, product sales increased from 64% in the second quarter of 2008 to 67% in the current year quarter. The dollar decrease in product sales was primarily due to a decrease in revenue from the sale of biometric software, which was partially offset by an increase in revenue from the sale of test and diagnostic hardware and software.

For the six months ended June 30, 2009, product sales decreased 15% from $7.9 million in 2008 to $6.7 million in 2009. As a percentage of total revenue, product sales decreased from 65.4% in the first six months of 2008 to 64.5% in the corresponding period of 2009. The dollar decrease in product sales was primarily due to a decrease in revenue from the sale of biometric software, which was partially offset by an increase in revenue from the sale of test and diagnostic software.

Contract Revenue. Contract revenue consists of patent, license and engineering service fees that we receive under agreements relating to the sale or license of Aware's patents, DSL technology, DSL test and diagnostics technology, and biometrics technology.

Contract revenue decreased 19% from $1.8 million in the second quarter of 2008 to $1.4 million in the current year quarter. As a percentage of total revenue, contract revenue decreased from 29% in the second quarter of 2008 to 25% in the current year quarter.

For the six months ended June 30, 2009, contract revenue decreased 18% from $3.3 million in 2008 to $2.7 million in 2009. As a percentage of total revenue, contract revenue decreased from 27% in the first six months of 2008 to 26% in the corresponding period of 2009.

For the three and six month periods, the dollar decrease was primarily due to lower contract revenue from biometrics technology contracts, which was partially offset by an increase in contract revenue from DSL technology contracts. Revenue from biometrics technology contracts was lower in the current year periods primarily because revenue from a large project that commenced in late 2007 was lower.

Although revenue from DSL technology contracts was slightly higher in the current year periods, the environment for licensing DSL technology over the last few years has been characterized by uncertainty in the semiconductor and telecommunications industries, consolidation in the DSL semiconductor industry, and intense competition and falling prices for DSL chipsets. During the last several years, we have seen customers and potential customers cautiously evaluate new chipset projects or delay or cancel projects in the face of such conditions. Moreover, in the recent past, three of our licensees decided to exit the DSL chipset business altogether. As a result of these conditions, we expect that our ability to grow or maintain revenue from these activities in the future will be challenging.

On July 7, 2009 Infineon Technologies AG announced that it had agreed to sell its Wireline Communications business, our largest DSL semiconductor licensing customer, to a U.S. investor. It is too soon to assess the impact of this potential sale on our business, but we do not expect any changes to our contractual rights or obligations as a result of this transaction.

Royalties. Royalties consist of royalty payments that we receive under agreements with our customers. We receive royalties from customers for rights to Aware technology and/or patents, typically associated with the incorporation of Aware technology and/or patents in customer chipsets or solutions.

Royalties increased 6% from $443,000 in the second quarter of 2008 to $470,000 in the current year quarter. As a percentage of total revenue, royalties increased from 7% in the second quarter of 2008 to 8% in the current year quarter.

For the six months ended June 30, 2009, royalties increased 8% from $874,000 in 2008 to $947,000 in 2009. As a percentage of total revenue, royalties increased from 7% in the first six months of 2008 to 9% in the corresponding period of 2009.

For the three and six month periods, the dollar increase in royalties was primarily due to an increase in ADSL and VDSL royalties.

Our royalty revenue comes predominantly from ADSL chipset sales by Ikanos Communications, Inc. (“Ikanos”) and ADSL and VDSL chipset sales by Infineon Technologies AG (“Infineon”). Despite steady growth of worldwide DSL subscribers over the last several years, the availability of DSL chipsets from a number of suppliers has caused intense competition among those suppliers. We are uncertain as to whether our licensees will be able to maintain their market shares and chipset prices in the face of such competition, and whether our relationships with them will contribute meaningful royalties to us in the future.

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 67% from $624,000 in the second quarter of 2008 to $1.0 million in the current year quarter. As a percentage of product sales, cost of product sales increased from 16% in the second quarter of 2008 to 27% in the current year quarter, which resulted in gross margins on product sales decreasing from 84% to 73%. The cost of product sales dollar increase was primarily due to higher sales of test and diagnostics hardware. The decrease in product gross margins was primarily due to a greater proportion of hardware sales in product sales in the current quarter versus the year ago quarter.

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For the six months ended June 30, 2009, cost of product sales increased 7% from $1.45 million in 2008 to $1.56 million in 2009. As a percentage of product sales, cost of product sales increased from 18% in the first six months of 2008 to 23% in the corresponding period of 2009, which resulted in gross margins on product sales decreasing from 82% to 77%. The cost of product sales dollar increase was primarily due to the mix of hardware products sold in the current year period versus the prior year period. The decrease in product gross margins was primarily due to a greater proportion of hardware sales in product sales in the current quarter versus the year ago quarter.

Cost of Contract Revenue. Cost of contract revenue consists primarily of compensation costs for engineers and expenses for consultants, technology licensing fees, recruiting, supplies, equipment, depreciation and facilities associated with customer development projects. Our total engineering costs are allocated between cost of contract revenue and research and development expense. In a given period, the allocation of engineering costs between cost of contract revenue and research and development is a function of the level of effort expended on each.

Cost of contract revenue decreased 20% from $1.1 million in the second quarter of 2008 to $0.9 million in the current year quarter. Cost of contract revenue as a percentage of contract revenue, decreased from 64% in the second quarter of 2008 to 63% in the current quarter, which resulted in gross margins on contract revenue increasing from 36% to 37%.

For the six months ended June 30, 2009, cost of contract revenue decreased 15% from $2.1 million in the first six months of 2008 to $1.8 million in the corresponding period of 2009. Cost of contract revenue as a percentage of contract revenue increased from 65% in the first six months of 2008 to 67% in the corresponding period of 2009, which resulted in gross margins on contract revenue decreasing from 35% to 33%.

For the three and six month periods, the dollar decrease in cost of contract revenue was primarily due to lower revenue from biometrics contracts. Lower cost of contract revenue from biometrics contracts was partially offset by increased cost of contract revenue from DSL contracts.

Research and Development Expense. Research and development expense consists primarily of compensation costs for engineers and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities related to engineering projects to improve our broadband intellectual property offerings, as well as our software and hardware product technology.

Research and development expenses decreased 13% from $3.5 million in the second quarter of 2008 to $3.1 million in the current year quarter. As a percentage of total revenue, research and development expense decreased from 57% in the second quarter of 2008 to 53% in the current year quarter.

Research and development expenses decreased 12% from $7.0 million in the first six months of 2008 to $6.2 million in the first six months of 2009. As a percentage of total revenue, research and development expense increased from 58% in the first six months of 2008 to 60% in the corresponding period of 2009.

For the three and six month periods, the dollar decrease in research and development expense was primarily due to: i) headcount attrition in our engineering organization over the past year and lower spending on design and other outside services; and ii) a shift of engineering resources from internal development projects (i.e., research and development expense) to DSL customer contracts (i.e., cost of contract revenue).

Our research and development spending was principally focused on developing analog and digital silicon IP solutions for broadband communications applications, developing test and diagnostics hardware and software, and developing biometrics and imaging software.

Selling and Marketing Expense. Selling and marketing expense consists primarily of compensation costs for sales and marketing personnel, travel, advertising and promotion, recruiting, and facilities expense.

Sales and marketing expense was essentially unchanged at $1.2 million in the second quarters of 2008 and 2009. As a percentage of total revenue, sales and marketing expense increased from 19% in the second quarter of 2008 to 21% in the current year quarter. Level sales and marketing expense in second quarter of 2009 reflected increased expenses for headcount growth in our biometrics sales organization, which was offset by lower biometrics sales commissions and DSL tradeshow expenses.

For the six months ended June 30, 2009, sales and marketing expenses increased 5%, from $2.2 million in 2008 to $2.3 million in 2009. As a percentage of total revenue, sales and marketing expenses increased from 18% in the first six months of 2008 to 22% in the corresponding period of 2009. The dollar increase was mainly attributable to headcount growth in our biometrics sales organization, which was partially offset by lower biometrics sales commissions and DSL tradeshow expenses.

General and Administrative Expense. General and administrative expense consists primarily of compensation costs for administrative personnel, facility costs, bad debt, audit, legal, stock exchange and insurance expenses.

General and administrative expenses decreased 5% from $1.3 million in the second quarter of 2008 to $1.2 million in the current year quarter. As a percentage of total revenue, general and administrative expense in the second quarter of 2009 was unchanged at 21% from the previous year.

For the six months ended June 30, 2009, general and administrative expenses decreased 2% from $2.5 million in 2008 to $2.4 million in 2009. As a percentage of total revenue, general and administrative expenses increased from 21% in the first six months of 2008 to 24% in the corresponding period of 2009.

For the three and six month periods, the dollar decrease was mainly attributable to lower legal fees, salary expenses, and a one-time payment to a former director. Lower expenses from these items were partially offset by increased stock-based compensation charges, bonus expenses, and director compensation expense.

Interest Income. Interest income decreased 81% from $315,000 in the second quarter of 2008 to $61,000 in the current year quarter. The dollar decrease was primarily due to a substantial decline in money market interest rates and lower cash balances due to the use of cash to repurchase our stock.

For the six months ended June 30, 2009, interest income decreased 73%, from $698,000 in 2008 to $186,000 in 2009. The dollar decrease was primarily due to a substantial decline in money market interest rates.

Income Taxes. We made no provision for income taxes in the first three months of 2009 and 2008 due to net losses incurred and the uncertainty of the timing of profitability in future periods, except for $1,000 and $4,000 of state excise tax paid in the second quarter of 2009 and 2008, respectively. In 2002, we determined that due to our continuing operating losses as well as the uncertainty of the timing of profitability in future periods, we should fully reserve our deferred tax assets. As of June 30, 2009, our deferred tax assets continue to be fully reserved. We will continue to evaluate, on a quarterly basis, the positive and negative evidence affecting the realizability of our deferred tax assets.

As of December 31, 2008, we had federal net operating loss and research and experimentation credit carryforwards of approximately $46.5 million and $12.8 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2009 through 2029. In addition, at December 31, 2008, we had approximately $11.4 million and $6.6 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2009 through 2023.

Based on an analysis that we performed under Internal Revenue Code Section 382 on our NOLs generated for the period 1997 through 2007, 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.

Liquidity and Capital Resources

At June 30, 2009, we had cash and cash equivalents of $31.9 million, which represents a decrease of $13.7 million from December 31, 2008. The decrease in cash was primarily due to: i) cash used by operations of $4.6 million; ii) repurchases of our common stock of $9.0 million; and iii) capital spending on equipment of $0.1 million.

Cash used by operations in the first six months of 2009 of $4.6 million was primarily the result of two factors: i) a net loss of $3.7 million, which was reduced for non-cash items related to depreciation and amortization of $0.4 million, and stock based compensation expense of $0.8 million; and ii) $2.1 million of cash used to fund working capital items.

In the second quarter of 2009, we completed a modified Dutch auction self-tender offer. We repurchased 3,500,252 shares at $2.50 per share for a total cost of $9.0 million, including expenses.

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

While we can not 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

In May 2009, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 165, “Subsequent Events,” which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. SFAS No. 165 provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The Company adopted SFAS No. 165 during the second quarter of 2009, and its application had no impact on the Company’s consolidated financial statements.

In June 2009, the FASB issued Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles. Statement No. 168 replaces FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles, and establishes the FASB Accounting Standards Codification TM (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). Statement No. 168 is effective for interim and annual periods ending after September 15, 2009. The Company will begin to use the new Codification when referring to GAAP in its quarterly report on Form 10-Q for the fiscal period ending September 30, 2009. This will not have an impact on the consolidated results of the Company.

In September 2006, the FASB issued SFAS No. 157 ("SFAS 157"), "Fair Value Measurements," which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on February 6, 2008, the FASB issued FSP FAS 157-b which defers the effective date of SFAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. We adopted SFAS 157 on January 1, 2008, except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-b. We adopted FSP FAS 157-b on January 1, 2009. The adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard ("SFAS") No. 160, “Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51.” SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This accounting standard is effective for fiscal years beginning after December 15, 2008. We adopted SFAS 160 on January 1, 2009. The adoption of SFAS 160 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard ("SFAS") No. 141(R), “Business Combinations.” SFAS 141(R) establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, an any noncontrolling interest in the acquiree, recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This accounting standard is effective for fiscal years beginning after December 15, 2008. We adopted SFAS 141(R) on January 1, 2009. The adoption of SFAS 141(R) did not have a material impact on our consolidated financial position, results of operations or cash flows as of the date of adoption. SFAS 141(R) will be applied to any future business combinations.

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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, 2009, our cash and cash equivalents of $31.9 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, 2009, 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 chief executive officer 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

Risk Factors

Our Quarterly Results are Unpredictable and May Fluctuate Significantly

Our quarterly revenue and operating results are difficult to predict and may fluctuate significantly from quarter-to-quarter due to the unpredictably of our revenue components.

It is difficult for us to make accurate forecasts of product revenues. Product revenues consist of sales of test and diagnostics hardware as well as biometrics, medical imaging and test and diagnostics software. Sales of hardware and software products fluctuate based upon demand by our customers which is difficult to predict. Since our product revenues include the sales of hardware products which typically have lower gross margins than our other sources of revenue, product gross margins and overall profitability are also difficult to predict.

Contract revenues are also unpredictable. Making accurate predictions of contract revenues from new customers is difficult. The contract negotiation process can be lengthy and the fiscal period in which a new agreement will be entered into, if at all, and the financial terms of such an agreement are difficult to predict. Making accurate predictions of contract revenues from existing customers is also difficult, because such revenues are affected by the level of cooperation we receive from customers; the level of engineering services desired by customers; and the potential of contract termination once a project starts. In addition, customers may not pay us as anticipated under our contracts.

It is also difficult for us to make accurate forecasts of royalty revenues. Royalties are typically recognized in the quarter when we receive a report from a customer detailing sales and royalties due from the prior quarter, such as from the shipment of licensed integrated circuits. Royalties depend upon customer revenues which can be affected by factors beyond our ability to control or assess in advance. These factors include our customers’ ability to generate sales and fluctuating sales volumes and prices of products containing our technology.

Our business is subject to a variety of additional risks, which could materially adversely affect quarterly and annual operating results, including:

- market acceptance of broadband technologies we supply by semiconductor or equipment companies;
- the extent and timing of new transactions with customers;
- changes in our and our customers' development schedules and levels of expenditure on research and development;
- the loss of a strategic relationship or termination of a project by a customer;
- equipment companies' acceptance of integrated circuits produced by our customers;
- the loss by a customer of a strategic relationship with an equipment company customer;
- announcements or introductions of new technologies or products by us or our competitors;
- delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- failures or problems in our hardware or software products;
- price pressure in the biometrics or test and diagnostics markets from our competitors;
- delays in the adoption of new industry standards or changes in market perception of the value of new or existing standards;
- competitive pressures resulting in lower contract revenues or royalty rates;
- competitive pressures resulting in lower software or hardware product revenues;
- personnel changes, particularly those involving engineering, technical, sales and marketing personnel;
- costs associated with protecting our intellectual property;
- the potential that customers could fail to make payments under their current contracts;
- ADSL or VDSL market-related issues, including lower ADSL or VDSL chipset unit demand brought on by excess channel inventory and lower average selling prices for ADSL or VDSL chipsets as a result of market surpluses;
- hardware manufacturing issues, including yield problems in our hardware platforms, and inventory buildup and obsolescence;
- product gross margin may be affected by various factors including, but not limited to, product mix, product life cycle, and provision for excess and obsolete inventory;
- significant fluctuations in demand for our hardware products;
- new laws, changes to existing laws, or regulatory developments; and
- general economic trends and other factors.

As a result of these factors, we believe that period-to-period comparisons of our revenue levels and operating results are not necessarily meaningful. You should not rely on our quarterly revenue and operating results to predict our future performance.

We Experienced Net Losses

We had a net annual loss during 2001, 2002, 2003, 2004, and 2005; and quarterly losses in the first two quarters of 2009. We may experience losses in the future if:

- the test and diagnostics, semiconductor, telecommunications or biometrics markets decline;
- new and/or existing customers do not choose to use our software or hardware products;
- new and/or existing customers do not choose to license and/or buy our patents; or
- new and/or existing customers do not choose to license our silicon IP for new chipset products or do not maintain or increase their revenues from sales of chipsets with our technology.

Our DSL Licensing and DSL Test and Diagnostics Businesses Depend Upon a Limited Number of Customers, Therefore We Derive a Significant Amount of Revenue from a Small Number of Customers

There are a relatively limited number of companies to which we can sell our DSL technology and a limited number of OEM suppliers to which we can sell our DSL test and diagnostics products in a manner consistent with our business model. If we fail to maintain relationships with our current customers or fail to establish a sufficient number of new customer relationships, our business could be seriously harmed. In the recent past, three of our DSL silicon IP customers decided to exit the DSL chipset business, and therefore we do not expect to generate additional revenue from these customers. In addition, our current and prospective customers may use their superior size and bargaining power to demand terms that are unfavorable to us.

Due to the limited number of customers to which we can license and/or sell our DSL technology and patents and our DSL hardware and software products, we derive a significant amount of revenue from a small number of customers. In 2008, we derived approximately 28% and 12% of our total revenue from Daphimo and Infineon, respectively. In 2007, we derived approximately 19%, 16%, and 10% of our total revenue from Infineon, Spirent, and Alcatel, respectively. In 2006, we derived approximately 26% and 20% of our total revenue from Infineon and ADI/Ikanos, respectively. On February 17, 2006 ADI sold its ADSL business relating to Aware technology to Ikanos and Ikanos replaced ADI as an Aware customer. On July 7, 2009 Infineon announced that it had agreed to sell its Wireline Communications business, our largest DSL semiconductor licensing customer, to a U.S. investor. It is too soon to access the impact of the potential sale by Infineon on our business.

Our Business is Subject to Rapid Technological Change

The semiconductor and telecommunications industries for high-speed network access technologies are characterized by rapid technological change. The biometrics industry is also subject to rapid technological change and uncertainty. In these industries, new generations of products are introduced regularly and evolutionary improvements to existing products are required. Therefore, we face risks that others could introduce competing technology that renders our DSL or biometrics technology and products less desirable or obsolete. Also, the announcement of new technologies could cause our customers or their customers to delay or defer entering into arrangements for the use of our existing technology. Either of these events could seriously harm our business.

We expect that our business will depend to a significant extent on our ability to introduce new generations of communications and biometrics products as well as new technologies and products that keep pace with changes in these industries. We must continually devote significant engineering resources to achieving technical innovations and product developments. These developments are complex and require long development cycles. Moreover, we may have to make substantial investments in technological innovations and product developments before we can determine their commercial viability. We may lack sufficient financial resources to fund future development. Also, our customers may decide not to share certain research and development costs with us. Revenue from technological innovations, even if successfully developed, may not be sufficient to recoup the costs of development.

One element of our business strategy is to assume the risks of technology development failure while reducing such risks for our customers. In the past, we have spent significant amounts on development projects that did not produce any marketable technologies or products, and we cannot assure you that it will not occur again.

We Face Intense Competition from a Wide Range of Competitors

Our ability to generate revenues from our DSL technology depends largely on the willingness and ability of semiconductor manufacturers to design, build and sell integrated circuits based on our intellectual property. The DSL semiconductor industry is intensely competitive and has been characterized by price erosion, rapid technological change, short product life cycles, cyclical market patterns and increasing foreign and domestic competition.

As a silicon intellectual property supplier to the semiconductor industry, we face competition from internal development teams within potential semiconductor customers. We must convince potential customers to license or buy from us rather than develop technology internally. Furthermore, our semiconductor customers may choose to abandon joint development projects with us or develop chipsets themselves without using our technology. In addition to competition from internal development teams, we may compete against other independent suppliers of intellectual property for DSL. New chipset suppliers have also demonstrated a reluctance to enter the DSL market.

The market for DSL chipsets is intensely competitive. Our success as a silicon IP supplier requires that DSL equipment manufacturers buy chipsets from our semiconductor customers, and that telephone companies buy DSL equipment from those equipment manufacturers. Our customers' chipsets compete with products from other vendors of standards-based DSL chipsets, including Broadcom, Conexant, and TrendChip.

The markets for our DSL test and diagnostics hardware and software products are competitive and uncertain. We can give no assurance that phone companies will purchase significant quantities of products to test and maintain their DSL networks, or that if they do they will use our products. Our success as a supplier of hardware and software products for DSL test and diagnostics depends in large part on the willingness and ability of OEM customers to design, build and sell automated test heads, hand-held testers, and DSLAMs that incorporate or work with our products. Our success also depends upon our ability to market and sell to service providers.

Our DSL customers and their competitors have significantly greater financial, technological, manufacturing, marketing and personnel resources than we do. We can give no assurance that our OEM customers will continue to purchase products from us or that we will be able to compete effectively or that competitive pressures will not seriously harm our business.

Our DSL licensing and DSL test and diagnostics revenues are dependent upon the success of ADSL and VDSL services. ADSL and VDSL services offered over copper telephone networks also compete with alternative broadband transmission technologies that use other network architectures. Alternative technologies that use other network architectures to provide high-speed data service include cable modems using cable networks, wireless solutions using wireless networks, and optics technology using fiber optic networks. These alternative broadband transmission technologies may be more successful than ADSL or VDSL and we may not be able to participate in the markets involving these alternative technologies.

The markets for our biometrics products and services as well as our medical and digital imaging software products are competitive and uncertain. Many of our biometric software competitors have significantly greater financial, technological, marketing and personnel resources than we do. Also, we face intense competition from internal development teams within potential customers. We must convince potential customers to purchase products and services from us rather than develop software or perform services internally. Furthermore, customers, who have already purchased from us, may choose to stop purchasing our software and develop their own software.

We may be unable to compete successfully in our DSL licensing, DSL test and diagnostics, and biometrics and imaging businesses, and our competitive position may be adversely affected in the future by one or more of the factors described in this section.

Our Intellectual Property is Subject to Limited Protection

Because we are a technology provider, our ability to protect our intellectual property and to operate without infringing the intellectual property rights of others is critical to our success. We regard our technology as proprietary. Our patent portfolio includes approximately 44 U.S. patents and 100 foreign patents as well as a number of pending patent applications. We also rely on a combination of trade secrets, copyright and trademark law and non-disclosure agreements to protect our unpatented intellectual property. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our technology without authorization.

As part of our silicon IP agreements, we typically work closely with our customers, who may also be potential competitors, and provide them with proprietary know-how necessary for their development of customized chipsets based on our DSL technology. Although our agreements contain non-disclosure provisions and other terms protecting our proprietary know-how and technology rights, it is possible that, despite these precautions, some of our customers might obtain from us proprietary information that they could use to compete with us in the marketplace. Although we intend to defend our intellectual property as necessary, the steps we have taken may be inadequate to prevent misappropriation.

In the future, we may be involved in legal action to enforce our intellectual property rights relating to our patents, copyrights or trade secrets. Any such litigation could be costly and time-consuming for us, even if we were to prevail. Moreover, even if we are successful in protecting our proprietary information, our competitors may independently develop technologies substantially equivalent or superior to our technology. The misappropriation of our technology or the development of competitive technology could seriously harm our business.

Our technology, software or hardware may infringe the intellectual property rights of others. A large and increasing number of participants in the telecommunications and compression industries have applied for or obtained patents. Some of these patent holders have demonstrated a readiness to commence litigation based on allegations of patent and other intellectual property infringement. Third parties may assert patent, copyright and other intellectual property rights to technologies that are important to our business. In the past, we have received claims from other companies that our technology infringes their patent rights. Intellectual property rights can be uncertain and can involve complex legal and factual questions. We may infringe the proprietary rights of others, which could result in significant liability for us. If we were found to have infringed any third party’s patents, we could be subject to substantial damages or an injunction preventing us from conducting our business.

Our Ability to Obtain or Enforce Patents Could be Affected by New Laws, Regulations or Rules

We have an active program to protect our proprietary technology through the filing of patents. We have also pursued the license and/or sale of patents, as part of our silicon IP offerings as well as independently. New laws, regulations or rules implemented either by Congress, the United States Patent and Trademark Office, foreign patent offices, or the courts that impact the patent application process, the patent enforcement process or the rights of patent holders could significantly increase our expenses related to patent prosecution or decrease revenues associated with our patents. While we are not aware that any such changes are likely to occur in the foreseeable future, we cannot assure you that such changes will not occur.

Our DSL Silicon Intellectual Property Business Model Has Unique Challenges

Our success as a licensor of DSL silicon IP depends upon our ability to license our technology to semiconductor or equipment companies, and our customers' willingness and ability to sell products that incorporate our technology.

We face numerous risks in successfully obtaining suitable customers on terms consistent with our business model, including, among others:

- we must typically undergo a lengthy and expensive process of building a relationship with a potential customer before there is any assurance of an agreement with such party, and in some instances we must convince a potential customer to enter the DSL market.
- we must persuade semiconductor and equipment manufacturers with significant resources to rely on us for critical technology on an ongoing basis rather than trying to develop similar technology internally;
- we must persuade potential customers to bear development costs associated with our technology applications and to make the necessary investment to successfully manufacture chipsets and products using our technology; and
- we must successfully transfer technical know-how to customers.

Moreover, the success of our business model also depends on the receipt of royalties from customers. Royalties from our customers are often based on the selling prices of their chipsets and products, over which we have little or no control. We also have little or no control over our customers' promotional and marketing efforts. They are not prohibited from competing against us.

Our success depends upon our ability to obtain suitable customers, and is threatened if our current customers cancel or put DSL programs utilizing our technology on hold, or if our customers do not successfully market and sell chipsets or products incorporating our technology.

There Has Been and May Continue to be a Cyclical Demand for DSL Chipsets, and There is Intense Competition for DSL Chipsets, Which Has Caused Our Royalty Revenue to Decline

The royalties we receive are influenced by many of the risks faced by the DSL market in general, including cyclical demand which may result in reduced average selling prices ("ASPs") for DSL chipsets during periods of surplus. In the past, the DSL industry has experienced an oversupply of DSL chipsets, central office equipment or customer premises equipment. Excessive inventory levels led to soft chipset demand, which in turn led to declining ASPs. ASPs have also been under pressure because of intense competition in the DSL chipset marketplace. As a result of the soft demand and declining ASPs for ADSL chipsets, our royalty revenue has decreased substantially. Price decreases for ADSL or VDSL chipsets, and the corresponding decreases in per unit royalties received by us, can be sudden and dramatic. Pricing pressures may continue during 2009 and beyond. Our royalty revenue may decline over the long term.

The Success of Our DSL Licensing Business Requires Acceptance of Our Technology by Equipment Companies

The success of our DSL licensing business is dependent on our ability to generate meaningful royalties from our licensing arrangements with customers. Our ability to generate such royalties is materially affected by the willingness of equipment companies to purchase integrated circuits that incorporate our technology. There are other competitive solutions available for equipment companies seeking to offer broadband communications products. We face the risk that equipment manufacturers will choose those alternative solutions. Generally, our ability to influence equipment companies' decisions whether to purchase integrated circuits that incorporate our technology is limited.

We also face the risk that equipment companies that elect to use integrated circuits that incorporate our technology into their products will not compete successfully against other equipment companies. Many factors beyond our control could influence the success or failure of a particular equipment company that uses integrated circuits based on our technology. Even if equipment companies incorporate chipsets based on our intellectual property into their products, their products may not achieve commercial acceptance or result in meaningful royalties to us.

The Success of Our DSL Licensing and Test and Diagnostics Products Businesses Requires Telephone Companies to Install DSL Service in Volume

The success of our DSL licensing and test and diagnostics products businesses depends upon telephone companies installing DSL service in significant volumes. If telephone companies do not install DSL service in significant volumes, or if telephone companies install broadband service based on other technologies such as cable or fiber-to-the-home, our business will be seriously harmed.

Moreover, our DSL licensing and test and diagnostics products businesses depend on capital equipment spending by telephone companies. If telephone companies reduce their budgets for or decide not to install or utilize equipment dedicated to DSL service or test infrastructure, our business will be severely harmed.

The Success of Our DSL Test and Diagnostics Products Depends On a Number of Factors

Our success in developing, introducing, selling, and supporting new and enhanced test and diagnostics products depends upon a variety of factors, including timely and efficient completion of hardware and software design and development, implementation of manufacturing processes, and effective sales, marketing, and customer service. Because of the complexity of our test and diagnostics products, significant delays may occur between a hardware product's initial introduction and commencement of volume production. If we are unsuccessful in developing, introducing, selling and supporting new and enhanced test and diagnostics products, our DSL test and diagnostics business could be seriously harmed.

If Our Test and Diagnostics Hardware and Software Products Have Quality Problems, Our Business Could Be Harmed

If our test and diagnostics products have actual or perceived reliability, quality, functionality or other problems, we may suffer reduced orders, higher manufacturing costs, inability to recognize revenue, delays in collecting accounts receivable and higher service, support and warranty expenses or inventory write-offs, among other effects. We believe that the acceptance, volume production, timely delivery and customer satisfaction of our test and diagnostics products is important to our future financial results. As a result, any inability to correct any technical, reliability, parts shortages or other difficulties or to manufacture and ship our test and diagnostics products on a timely basis meeting customer requirements could damage our relationships and reputation with current and prospective customers, which would harm our revenues and operating results. Any product problems that may require repair or replacement may adversely affect our customer and/or vendor relationships and have an impact on support costs, warranty reserves, or inventory reserves, among other effects.

We are Dependent On a Single Source Contract Manufacturer for the Manufacture of Our DSL Hardware Products, the Loss of Which Would Harm Our Business

We currently depend on one contract manufacturer to manufacture our DSL hardware products. If this company was to terminate its arrangement with us or fail to provide the required capacity and quality on a timely basis, we would be unable to manufacture our products until replacement contract manufacturing services could be obtained. To qualify a new contract manufacturer, familiarize it with our products, quality standards and other requirements, and commence production is a costly and time-consuming process. We cannot assure you that we would be able to establish alternative manufacturing relationships on acceptable terms. Although we make reasonable efforts to ensure that our contract manufacturer performs to our standards, our reliance on a single source limits our control over quality assurance and delivery schedules. Defects in workmanship, unacceptable yields, and manufacturing disruptions and difficulties may impair our ability to manage inventory and cause delays in shipments and cancellation of orders that may adversely affect our relationships with current and prospective customers. As a result, our revenues and operating results may be harmed.

Our Manufacturing Systems May Not Be Adequate For Our DSL Test and Diagnostics Hardware Product Offerings

Our current manufacturing systems adequately address hardware products we are currently manufacturing in limited volumes. Our manufacturing systems have not been extensively tested under anticipated, more complex hardware products or in volumes higher than that of our current hardware products. If our manufacturing systems are inadequate or have other problems, our revenues and operating results may be harmed.

We are Dependent on Single Source Suppliers for Components in Our DSL Hardware Products

We rely on single source suppliers for components and materials used in our DSL hardware products. Our dependence on single source suppliers involves several risks, including limited control over pricing, availability, quality and delivery schedules. Any delays in delivery of such components or shortages of such components could cause delays in the shipment of our products, which could significantly harm our business. Because of our reliance on these vendors, we may also be subject to increases in component costs. These increases could significantly harm our business. If any one or more of our single source suppliers cease to provide us with sufficient quantities of our components in a timely manner or on terms acceptable to us, we would have to seek alternative sources of supply. We could incur delays while we locate and engage alternative qualified suppliers and we might be unable to engage alternative suppliers on favorable terms. We could incur substantial hardware and software redesign costs if we are required to replace the components. Any such disruption or increased expenses could harm our commercialization efforts and adversely affect our ability to generate revenues.

Biometrics Software Business Risks

Our biometrics software business is subject to a variety of additional risks, which could materially adversely affect quarterly and annual revenue and operating results, including:

- market acceptance of our biometric technologies and products;
- changes in contracting practices of government or law enforcement agencies;
- the failure of the biometrics market to experience continued growth;
- announcements or introductions of new technologies or products by our competitors;
- delays or problems in the introduction or performance of enhancements or of future generations of our technology;
- failures or problems in our biometric software products;
- the risk that current or potential customers might decide to develop their own software rather than buy it from us;
- delays in the adoption of new industry biometric standards or changes in market perception of the value of new or existing standards;
- growth of proprietary biometric systems which do not conform to industry standards;
- competitive pressures resulting in lower software product revenues;
- personnel changes, particularly those involving engineering, technical and sales and marketing personnel;
- costs associated with protecting our intellectual property;
- litigation by third parties for alleged infringement of their proprietary rights;
- the potential that customers could fail to make payments under their current contracts;
- new laws, changes to existing laws, or regulatory developments; and
- general economic trends and other factors.

Biometrics Services Business Risks

We began to perform engineering services under biometric technology contracts in the fourth quarter of 2007. Over the last several quarters, our biometrics services business has contributed a more meaningful portion of contract revenue. This business is subject to additional risks, which could materially adversely affect quarterly and annual revenue and operating results, including:

- our ability to structure and price technology contracts in a manner that is consistent with our business model;
- our ability to deliver contract milestones: i) in a timely and cost efficient manner, and ii) in a form and condition acceptable to customers;
- the risk that customers could terminate projects;
- the risk that we rely substantially on third party contractors and consultants to deliver certain contract milestones; and
- the potential that customers could fail to make payments under their contracts.

Current Economic Conditions, Including The Credit Crisis Affecting The Financial Markets And The Possibility Of A Global Recession, Could Adversely Affect Our Business, Results Of Operations And Financial Condition.

The world's financial markets are currently experiencing turmoil, characterized by reductions in available credit, increased costs of credit, volatility in security prices, rating downgrades of investments and reduced valuations of securities generally. These events have materially and adversely impacted the availability of financing to a wide variety of businesses, and the resulting uncertainty has led to reductions in capital investments, overall spending levels, future product plans, and sales projections across industries and markets. These trends could have a material adverse impact on our business, our ability to achieve targeted results of operations and our financial condition as a result of:

- reduced demand for our products or our customers' products that incorporate our technology;
- increased risk of order cancellations or delays;
- increased risk that customers may delay or terminate projects;
- increased pressure on the prices for our products or our customers' products that incorporate our technology;
- greater difficulty in collecting accounts receivable; and
- risks to our liquidity, including the possibility that we might not have access to our cash when needed.

We are unable to predict the likely duration and severity of the current disruption in financial markets and adverse economic conditions in the U.S. and other countries, but the longer the duration, the greater the risks we face in operating our business.

We Must Make Judgments in the Process of Preparing Our Financial Statements

We prepare our financial statements in accordance with generally accepted accounting principles and certain critical accounting polices that are relevant to our business. The application of these principles and policies requires us to make significant judgments and estimates. In the event that judgments and estimates we make are incorrect, we may have to change them, which could materially affect our financial position and results of operations.

Moreover, accounting standards have been subject to rapid change and evolving interpretations by accounting standards setting organizations over the past few years. The implementation of new standards requires us to interpret and apply them appropriately. If our current interpretations or applications are later found to be incorrect, our financial position and results of operations could be materially affected.

If We are Unable to Maintain Effective Internal Controls Over Financial Reporting, Investors Could Lose Confidence In The Reliability of Our Financial Statements, Which Could Result In a Decline in the Price of Our Common Stock

As a public company, we are required to enhance and test our financial, internal and management control systems to meet obligations imposed by the Sarbanes-Oxley Act of 2002. Consistent with the Sarbanes-Oxley Act and the rules and regulations of the SEC, management's assessment of our internal controls over financial reporting and the audit opinion of our independent registered accounting firm as to the effectiveness of our controls is required in connection with our filing of our Annual Report on Form 10-K. If we are unable to timely identify, implement and conclude that we have effective internal controls over financial reporting or if our independent auditors are unable to conclude that our internal controls over financial reporting are effective, investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our common stock. Our assessment of our internal controls over financial reporting may also uncover weaknesses or other issues with these controls that could also result in adverse investor reaction.

Our Stock Price May Be Extremely Volatile

Volatility in our stock price may negatively affect the price you may receive for your shares of common stock and increases the risk that we could be the subject of costly securities litigation. The market price of our common stock has fluctuated substantially and could continue to fluctuate based on a variety of factors, including:

- quarterly fluctuations in our operating results;
- changes in future financial guidance that we may provide to investors and public market analysts;
- changes in our relationships with our customers;
- announcements of technological innovations or new products by us, our customers or our competitors;
- changes in DSL or biometrics market growth rates as well as investor perceptions regarding the investment opportunity that companies participating in the DSL or biometrics industry afford them;
- changes in earnings estimates by public market analysts;
- key personnel losses;
- sales of our common stock;
- our stock repurchase activities; and
- developments or announcements with respect to industry standards, patents or proprietary rights.

In addition, the equity markets have experienced volatility that has particularly affected the market prices of equity securities of many high technology companies and that often has been unrelated or disproportionate to the operating performance of such companies. These broad market fluctuations may adversely affect the market price of our common stock.

Our Business May Be Affected by Government Regulations

The extensive regulation of the telecommunications industry by federal, state and foreign regulatory agencies, including the Federal Communications Commission, and various state public utility and service commissions, could affect us through the effects of such regulation on our customers and their customers. In addition, our business may also be affected by the imposition of certain tariffs, duties and other import restrictions on components that our customers obtain from non-domestic suppliers or by the imposition of export restrictions on products sold internationally and incorporating our technology. Changes in current or future laws or regulations, in the United States or elsewhere, could seriously harm our business.

ITEM 2:
Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1) (2)	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2009 to June 30, 20091	-	-	-	$ 7,603,874
April 1 to April 30, 20092	3,500,252	$ 2.50	3,500,252	-

(1) On August 28, 2007, we issued a press release announcing that our board of directors had approved the repurchase from time to time through December 31, 2008 of up to $5,000,000 of our common stock. On October 29, 2008, we announced that our board of directors had approved an amendment to the program that increased the total amount of common stock that may be repurchased from $5,000,000 to $10,000,000. The amendment also extended the period of time that shares may be repurchased from December 31, 2008 to December 31, 2009.

During 2007 and 2008, we purchased 9,107 and 712,024 shares, respectively, at a total cost of $38,716 and $2,357,410, respectively, under this plan. We did not purchase any shares under the plan in the first six months of 2009.

(2) On March 5, 2009, we announced a modified Dutch auction tender offer to purchase up to 3,500,000 shares of our common stock at a price per share of not less than $2.20 and not greater than $2.60. 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 4:
Submission of Matters to a Vote of Security Holders

On May 20, 2009, we held our Annual Meeting of Stockholders (the "Annual Meeting"). Matters voted on and the results of those votes are set forth below:

(1) Each of G. David Forney, Jr., Charles K. Stewart and Michael A. Tzannes was elected to serve as a Class I director of the Company for a term expiring at the annual meeting of stockholders of the Company in 2012 or a special meeting in lieu thereof. John K. Kerr, Mark G. McGrath, Adrian F. Kruse and Edmund C. Reiter continued to serve as directors following the Annual Meeting.

The votes cast to elect the Class I directors were:

Name	For	Withheld
G. David Forney, Jr.	15,496,051	1,279,111
Charles K. Stewart	15,498,040	1,277,122
Michael A. Tzannes	16,121,735	653,427

(2) The Company's existing equity plans were amended to allow for an option exchange program for employees other directors and executive officers.

The votes cast to amend the Company's existing equity plans were:

For	Against	Abstain	Non Votes
7,814,195	2,958,366	15,172	5,987,429

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ITEM 6:
Exhibits

(a) Exhibits

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of 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.

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.

Date: July 31, 2009	By: /s/ Michael A. Tzannes Michael A. Tzannes, Chief Executive Officer
Date: July 31, 2009	By: /s/ Richard P. Moberg Richard P. Moberg, Chief Financial Officer (Principal Financial and Accounting Officer)