AWARE INC /MA/
Form 10-Q
July 25, 2008

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, 2008

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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o Smaller Reporting Company o

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

Indicate the number of shares outstanding of the issuer's common stock as of July 22, 2008:

Class	Number of Shares Outstanding
Common Stock, par value $0.01 per share	23,766,175 shares

AWARE, INC.

FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2008

TABLE OF CONTENTS

		Page
PART I	FINANCIAL INFORMATION	
Item 1.	Unaudited Consolidated Financial Statements	
	Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007	3
	Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2008 and June 30, 2007	4
	Consolidated Statements of Cash Flows for the Three and Six Months Ended June 30, 2008 and June 30, 2007	5
	Notes to Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	16
Item 4.	Controls and Procedures	17
PART II	OTHER INFORMATION	
Item 1.	Legal Proceedings	18
Item 1A.	Risk Factors	18
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	28
Item 4.	Submission of Matters to a Vote of Security Holders	28
Item 6.	Exhibits	29
	Signatures	29

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

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 37,865	$ 1,806
Short-term investments	-	36,249
Accounts receivable, net	5,694	7,661
Inventories	2,070	1,424
Prepaid expenses and other current assets	573	708
Total current assets	46,202	47,848
Property and equipment, net	7,723	7,872
Investments	-	494
Other assets, net	135	169
Total assets	$ 54,060	$ 56,383
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 954	$ 939
Accrued expenses	136	174
Accrued compensation	1,118	1,135
Accrued professional	233	156
Deferred revenue	319	413
Total current liabilities	2,760	2,817
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, 23,766,175 as of June 30, 2008 and 23,854,708 as of December 31, 2007	238	239
Additional paid-in capital	83,900	83,626
Accumulated deficit	(33,168)	(30,629)
Total stockholders' equity	50,970	53,236
Total liabilities and stockholders' equity	$ 54,060	$ 56,383

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, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Revenue:				
Product sales	$ 3,948	$ 3,771	$ 7,872	$ 7,236
Contract revenue	1,776	1,575	3,298	3,409
Royalties	443	1,083	874	1,584
Total revenue	6,167	6,429	12,044	12,229
Costs and expenses:				
Cost of product sales	624	1,690	1,448	2,186
Cost of contract revenue	1,129	1,410	2,148	2,762
Research and development	3,511	2,650	7,039	5,206
Selling and marketing	1,186	999	2,155	1,872
General and administrative	1,285	1,144	2,478	2,260
Total costs and expenses	7,735	7,893	15,268	14,286
Loss from operations	(1,568)	(1,464)	(3,224)	(2,057)
Interest income	315	503	698	1,008
Loss before provision for income taxes	(1,253)	(961)	(2,526)	(1,049)
Provision for income taxes	4	7	13	17
Net loss	$ (1,257)	$ (968)	$ (2,539)	$ (1,066)
Net loss per share – basic	$ (0.05)	$ (0.04)	$ (0.11)	$ (0.05)
Net loss per share – diluted	$ (0.05)	$ (0.04)	$ (0.11)	$ (0.05)
Weighted average shares – basic	23,869	23,715	23,875	23,687
Weighted average shares - diluted	23,869	23,715	23,875	23,687

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,	
	2008	2007
Cash flows from operating activities:		
Net loss	$ (2,539)	$ (1,066)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	457	426
Stock based compensation	718	487
Provision for doubtful accounts	(19)	
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	1,986	(128)
Inventories	(646)	(337)
Prepaid expenses	135	419
Accounts payable	15	122
Accrued expenses	22	28
Deferred revenue	(94)	(526)
Net cash provided by (used in) operating activities	35	(575)
Cash flows from investing activities:		
Purchases of property and equipment	(274)	(345)
Sales of investments	38,743	10,255
Purchases of investments	(2,000)	(10,414)
Net cash provided by (used in) investing activities	36,469	(504)
Cash flows from financing activities:		
Proceeds from issuance of common stock	337	306
Repurchase of common stock	(782)	-
Net cash provided by (used in) financing activities	(445)	306
Increase (decrease) in cash and cash equivalents	36,059	(773)
Cash and cash equivalents, beginning of period	1,806	8,571
Cash and cash equivalents, end of period	$ 37,865	$ 7,798

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

5

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, 2008, and of operations and cash flows for the interim periods ended June 30, 2008 and 2007. 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, 2007 in conjunction with our 2007 Annual Report on Form 10-K.

The results of operations for the interim period ended June 30, 2008 are not necessarily indicative of the results to be expected for the year.

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. Our available for sale investments had a fair value of $36.7 million as of December 31, 2007 and were included in short-term investments and investments on our consolidated balance sheets. The fair value of these investments was determined using quoted prices in active markets and is considered a Level 1 input. Changes in the fair value of these investments have historically been insignificant. We had no available for sale investments at June 30, 2008.

Our cash and cash equivalents, including money market securities, are also classified 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, 2008	December 31, 2007
Raw materials	$ 2,055	$ 1,424
Finished goods	15	-
Total	$ 2,070	$ 1,424

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,	
	2008	2007	2008	2007
Net loss	$ (1,257)	$ (968)	$ (2,539)	$ (1,066)
Weighted average common shares outstanding	23,869	23,715	23,875	23,687
Additional dilutive common stock equivalents	-	-	-	-
Diluted shares outstanding	23,869	23,715	23,875	23,687
Net loss per share – basic and diluted	$ (0.05)	$ (0.04)	$ (0.11)	$ (0.05)

For the three month periods ended June 30, 2008 and 2007 potential common stock equivalents of 238,039 and 1,546,096, 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, 2008 and 2007 potential common stock equivalents of 448,568 and 1,517,117, 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, 2008 and 2007, options to purchase 4,455,998 and 2,285,575 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, 2008 and 2007, options to purchase 3,932,798 and 2,399,575 shares of common stock, respectively, were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock and thus would be anti-dilutive.

E) Stock-Based Compensation

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Cost of product sales	$ 3	$ 2	$ 6	$ 4
Cost of contract revenue	26	43	60	79
Research and development	160	99	327	184
Selling and marketing	50	25	81	46
General and administrative	154	83	244	174
Stock-based compensation expense	$ 393	$ 252	$ 718	$ 487

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. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options granted in the three and six month periods ended June 30, 2008 and June 30, 2007. For stock options issued prior to December 31, 2007, we used the simplified method as promulgated by SAB 107 for estimating the expected option term. For stock options issued subsequent to December 31, 2007, we used the calculated historical term of stock options in computing the expected option term. 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

We organize the company 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,	
	2008	2007	2008	2007
United States	$ 4,897	$ 3,566	$ 8,898	$ 7,615
Germany	856	1,735	2,371	2,740
Rest of World	414	1,128	775	1,874
	$ 6,167	$ 6,429	$ 12,044	$ 12,229

G) Income Taxes

As of December 31, 2007, we had federal net operating loss and research and experimentation credit carryforwards of approximately $46.1 million and $12.2 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2008 through 2027. In addition, at December 31, 2007, we had approximately $11.2 million and $6.2 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2008 through 2022.

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 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. The partial adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows, nor do we believe that the adoption of FSP FAS 157-b will have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159 ("SFAS 159"), “The Fair Value Option for Financial Assets and Financial Liabilities”. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value (“fair value option”). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument be reported in earnings at each subsequent reporting date. SFAS 159 was effective on January 1, 2008. We did not apply the fair value option to any of our outstanding instruments and therefore, SFAS 159 did not have an impact on our consolidated financial statements.

I) Share Repurchase Program

On August 28, 2007, we announced a stock repurchase program to purchase up to $5 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. The authorization to repurchase our stock expires on December 31, 2008. Repurchases of common stock under this program included 9,107 shares in 2007, and 216,991 shares for a total cost of $0.8 million during the three months ended June 30, 2008.

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 increased 5% from $3.8 million in the second quarter of 2007 to $3.9 million in the current year quarter. As a percentage of total revenue, product sales increased from 59% in the second quarter of 2007 to 64% in the current year quarter.

For the six months ended June 30, 2008, product sales increased 9% from $7.2 million in 2007 to $7.9 million in 2008. As a percentage of total revenue, product sales increased from 59% in the first six months of 2007 to 65% in the corresponding period of 2008.

For the three and six month periods, the dollar increase in product sales was primarily due to an increase in revenue from the sale of biometric software, which was partially offset by a decrease in revenue from the sale of test and diagnostic hardware and software.

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

Contract revenue increased 13% from $1.6 million in the second quarter of 2007 to $1.8 million in the current year quarter. As a percentage of total revenue, contract revenue increased from 25% in the second quarter of 2007 to 29% in the current year quarter. The dollar increase in contract revenue was due to higher revenue from biometrics technology contracts, which was partially offset by a decrease in revenue from DSL technology contracts. DSL contract revenue was lower because we performed less engineering services for existing customers, and we were unable to sign contracts with new customers.

For the six months ended June 30, 2008, contract revenue decreased 3% from $3.4 million in 2007 to $3.3 million in 2008. As a percentage of total revenue, contract revenue decreased from 28% in the first six months of 2007 to 27% in the corresponding period of 2008. The dollar decrease in contract revenue was primarily due to decreased revenue from DSL technology contracts, which was mostly offset by higher revenue from biometrics technology contracts.

While we believe that the transition to ADSL2+ and VDSL2 technology increases the value proposition of our technology, some existing and prospective DSL chipset licensees have continued to be reluctant to begin new development projects given a difficult and uncertain environment in the semiconductor and telecommunications industries, and intense ADSL chipset competition and falling chipset prices.

During the last several years, customers and potential customers cautiously evaluated new chipset projects or delayed or cancelled projects in the face of such conditions. Moreover, some of our existing customers have recently decided to exit the DSL chipset business altogether. During the first quarter of 2008, one of our unannounced DSL licensees notified us that it wished to terminate an ongoing development project with us as a result of its sale of certain DSL assets to another company. On July 15, 2008, we filed a lawsuit against this licensee seeking damages for breach of contract. In July 2008, Thomson, another one of our DSL licensees, announced that it was discontinuing its silicon solutions business. As a result of these customer actions, we do not expect to generate additional revenue from these DSL licensing contracts.

Royalties. Royalties consist of royalty payments that we receive under licensing agreements. We receive royalties from customers for the right to use our patents and technology in their chipsets or solutions.

Royalties decreased 59% from $1.1 million in the second quarter of 2007 to $0.4 million in the current year quarter. As a percentage of total revenue, royalties decreased from 17% in the second quarter of 2007 to 7% in the current year quarter.

For the six months ended June 30, 2008, royalties decreased 45% from $1.6 million in 2007 to $0.9 million in 2008. As a percentage of total revenue, royalties decreased from 13% in the first six months of 2007 to 7% in the corresponding period of 2008.

For the three and six month periods, the dollar decrease in royalties was primarily due to a decrease in ADSL royalties, and to a lesser degree, to a decrease in VDSL and medical imaging royalties.

Our royalty revenue comes predominantly from ADSL chipset sales by Ikanos Communications, Inc. (“Ikanos”), and Infineon Technologies AG (“Infineon”). Despite steady growth of worldwide ADSL subscribers over the last several years, the availability of ADSL chipsets from a number of suppliers and intense competition among those suppliers has caused chipset prices to steadily decline. We are uncertain how the transition to ADSL2+ and VDSL2 will impact our customers in the near term, how quickly sales of our customers’ chipsets will increase and whether such increases will contribute meaningful royalties to us.

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

Cost of product sales decreased 63% from $1.7 million in the second quarter of 2007 to $0.6 million in the current year quarter. As a percentage of product sales, cost of product sales decreased from 45% in the second quarter of 2007 to 16% in the current year quarter, which resulted in gross margins on product sales increasing from 55% to 84%.

For the six months ended June 30, 2008, cost of product sales decreased 34% from $2.2 million in 2007 to $1.4 million in 2008. As a percentage of product sales, cost of product sales decreased from 30% in the first six months of 2007 to 18% in the corresponding period of 2008, which resulted in gross margins on product sales increasing from 70% to 82%.

For the three and six month periods, the dollar decrease in cost of product sales was primarily due to lower sales of test and diagnostic hardware products. The increase in gross margins on product sales was primarily due to a greater proportion of software sales in the product sales mix.

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. Commencing in the fourth quarter of 2007, cost of contract revenue also includes direct expenses for third party contractors and consultants for biometrics technology contracts.

Cost of contract revenue decreased 20% from $1.4 million in the second quarter of 2007 to $1.1 million in the current year quarter. Cost of contract revenue as a percentage of contract revenue, was 90% in the second quarter of 2007 and 64% in the current quarter, which resulted in gross margins on contract revenue increasing from 10% to 36%.

For the six months ended June 30, 2008, cost of contract revenue decreased 22% from $2.8 million in the first six months of 2007 to $2.1 million in the corresponding period of 2008. Cost of contract revenue as a percentage of contract revenue decreased from 81% in the first six months of 2007 to 65% in the corresponding period of 2008, which resulted in gross margins on contract revenue increasing from 19% to 35%.

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

For the three and six month periods, the increase in gross margins on contract revenue was due to a greater proportion of higher-margin revenue from biometrics contracts in the contract revenue sales mix.

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. 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.

Research and development expenses increased 32% from $2.7 million in the second quarter of 2007 to $3.5 million in the current year quarter. As a percentage of total revenue, research and development expense increased from 41% in the second quarter of 2007 to 57% in the current year quarter.

Research and development expenses increased 35% from $5.2 million in the first six months of 2007 to $7.0 million in the first six months of 2008. As a percentage of total revenue, research and development expense increased from 43% in the first six months of 2007 to 58% in the corresponding period of 2008.

For the three and six month periods, the dollar increase in research and development expense was primarily due to a shift of engineering resources from DSL customer contracts (i.e., cost of contract revenue) to internal development projects (i.e., research and development expense). This resource shift reduced the amount of engineering expenses we allocated to cost of contract revenue, which increased research and development expense to reflect our increased focus on internal projects. To a much lesser extent, the dollar increase in research and development expense was also due to salary increases and higher stock-based compensation expense in the three and six month periods in 2008.

Our research and development spending was principally focused on improving our VDSL2 StratiPHY3™ technology and chips, developing home networking technology in support of the International Telecommunications Union's G.hn standard, developing analog front-end solutions for broadband 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 increased 19% from $1.0 million in the second quarter of 2007 to $1.2 million in the current year quarter. As a percentage of total revenue, sales and marketing expense increased from 15% in the second quarter of 2007 to 19% in the current year quarter.

For the six months ended June 30, 2008, sales and marketing expenses increased 15%, from $1.9 million in 2007 to $2.2 million in 2008. As a percentage of total revenue, sales and marketing expenses increased from 15% in the first six months of 2007 to 18% in the corresponding period of 2008.

For the three and six month periods, the dollar increase in sales and marketing expense was mainly attributable to salary increases, headcount growth in the sales organization, increased sales commissions on higher biometrics software sales, increased travel expenses, and higher stock-based compensation expense.

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 increased 12% from $1.1 million in the second quarter of 2007 to $1.3 million in the current year quarter. As a percentage of total revenue, general and administrative expense increased from 18% in the second quarter of 2007 to 21% in the current year quarter.

For the six months ended June 30, 2008, general and administrative expenses increased 10% from $2.3 million in 2007 to $2.5 million in 2008. As a percentage of total revenue, general and administrative expenses increased from 18% in the first six months of 2007 to 21% in the corresponding period of 2008.

For the three and six month periods, the dollar increase in general and administrative expense was mainly attributable to salary increases, higher stock-based compensation expense and legal fees, and a one-time payment to a former director.

Interest Income. Interest income decreased 37% from $503,000 in the second quarter of 2007 to $315,000 in the current year quarter. For the six months ended June 30, 2008, interest income decreased 31%, from $1,008,000 in 2007 to $698,000 in 2008.

For the three and six month periods, the dollar decrease in interest income was primarily due to a significant fall in money market interest rates during early 2008. The decrease was also due to a decision we made to liquidate our portfolio of auction rate securities and longer term debt instruments in the first quarter of 2008 and invest the proceeds into a lower-yielding, shorter-term, money market fund.

Income Taxes. We made no provision for income taxes in the first six months of 2007 and 2008 due to net losses incurred and the uncertainty of the timing of profitability in future periods, except for $13,000 and $17,000 of state excise tax paid in the first six months of 2008 and 2007, 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, 2008, 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, 2007, we had federal net operating loss and research and experimentation credit carryforwards of approximately $46.1 million and $12.2 million respectively, which may be available to offset future federal income tax liabilities and expire at various dates from 2008 through 2027. In addition, at December 31, 2007, we had approximately $11.2 million and $6.2 million of state net operating losses and state research and development and investment tax carryforwards, respectively, which expire at various dates from 2008 through 2022.

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, 2008, we had cash, cash equivalents, short-term investments, and investments of $37.9 million, which represents a decrease of $0.7 million from December 31, 2007. Cash provided by operations in the first six months of 2008 was $35,000. The decrease in cash was primarily due to $0.3 million of capital spending and $0.8 million of stock repurchases under a stock buyback program we announced in 2007. These uses of cash were partially offset by $0.3 million of proceeds from the exercise of employee stock options.

Cash provided by operations in the first six months of 2008 was primarily due to a reduction of non-cash working capital items of $1.4 million, which was almost entirely offset by a net loss of $2.5 million, adjusted for non-cash items related to depreciation and amortization of $0.5 million, and stock based compensation expense of $0.7 million. Capital spending was primarily related to the purchase of computer hardware, and laboratory equipment used principally in engineering activities.

15

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 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. The partial adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows, nor do we believe that the adoption of FSP FAS 157-b will have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159 ("SFAS 159"), “The Fair Value Option for Financial Assets and Financial Liabilities”. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value (“fair value option”). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument be reported in earnings at each subsequent reporting date. SFAS 159 was effective on January 1, 2008. We did not apply the fair value option to any of our outstanding instruments and therefore, SFAS 159 did not have an impact on our consolidated financial statements.

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; and
- —Investments, which consist of financial instruments that meet the high quality standards specified in our investment policy. This policy dictates that all instruments mature in three years or less, and limits the amount of credit exposure to any one issue, issuer, and type of instrument.

We do not use derivative financial instruments for speculative or trading purposes. As of June 30, 2008, we had $37.9 million in cash and cash equivalents primarily in money market accounts. Due to the 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. In January 2008, we liquidated all of our auction rate securities and invested the proceeds in a money market account. In April 2008, we liquidated the remainder of our investment portfolio of debt instruments and invested the proceeds in a money market account.

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, profitability is also difficult to predict.

Contract revenues are also unpredictable. Making accurate predictions of contract revenues from new customers is difficult because the contract negotiation process is lengthy, frequently spanning a year or more, 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; the potential of contract termination once a project starts, or 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 recognized in the quarter in which we receive a report from a customer regarding the shipment of integrated circuits in the prior quarter, and are dependent upon fluctuating sales volumes and/or prices of chips containing our technology, all of which are beyond our ability to control or assess in advance.

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 semiconductor companies;
- 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 and technical personnel;
- costs associated with protecting our intellectual property;
- the potential that customers could fail to make payments under their current contracts;
- ADSL market-related issues, including lower ADSL chipset unit demand brought on by excess channel inventory and lower average selling prices for ADSL chipsets as a result of market surpluses;
- VDSL market-related issues, including lower VDSL chipset unit demand brought on by excess channel inventory and lower average selling prices for 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;
- 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 a loss in the first six months of 2008. 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; or
- new and/or existing customers do not choose to use our intellectual property for new chipset products or do not increase their revenues from sales of chipsets with our technology.

Our DSL Licensing and DSL Test and Diagnostic 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 OEM equipment companies to which we can sell our DSL test and diagnostic 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 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 or sell our DSL technology and DSL hardware and software products, we derive a significant amount of revenue from a small number of customers. 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. In 2005, we derived approximately 30% and 20% of our total revenue from Infineon and ADI, respectively.

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, with new generations of products being introduced regularly and with ongoing evolutionary improvements. We expect to depend on our DSL technology and products for a substantial portion of our revenue for the foreseeable future. Therefore, we face risks that others could introduce competing technology that renders our DSL 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. The biometrics industry is also subject to rapid technological change and uncertainty.

We expect that our business will depend to a significant extent on our ability to introduce enhancements and new generations of our DSL and biometrics technology and products as well as new technologies and products that keep pace with changes in the telecommunications and broadband industries and that achieve rapid market acceptance. 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

The success of our DSL licensing business depends on the willingness and ability of semiconductor manufacturers to design, build and sell integrated circuits based on our intellectual property. The 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 an intellectual property supplier to the semiconductor industry, we face intense competition from internal development teams within potential semiconductor customers. We must convince potential customers to buy from us rather than develop technology internally. Furthermore, our semiconductor customers may choose to abandon joint development projects with us and develop chipsets themselves without using our technology. In addition to competition from internal development teams, we compete against other independent suppliers of intellectual property. We anticipate intense competition from suppliers of intellectual property for ADSL.

The market for DSL chipsets is also intensely competitive. Our success within the DSL industry 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 and DSL chipsets, including Broadcom, Conexant, Ikanos, and ST Microelectronics.

The markets for our DSL test and diagnostics hardware and software products are also competitive and uncertain. We cannot assure you that phone companies will purchase significant quantities of products to test and diagnose their DSL networks, nor that if they do they will purchase products incorporating our hardware and software. Our success as a supplier of hardware and software products for DSL test and diagnostics depends 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 DSL licensing and DSL test and diagnostic 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.

Many of our DSL competitors, including our customers' competitors, have significantly greater financial, technological, manufacturing, marketing and personnel resources than we do. Some of these competitors include Broadcom, Conexant, and ST Microelectronics in our DSL licensing business; and JDS Uniphase and Sunrise Communications in our DSL test and diagnostic business.

Also, the markets for our biometrics, 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 from us rather than develop software 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, and we have approximately 52 U.S. patents and 118 foreign patents and 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 agreements, we typically work closely with our customers, many of whom are also our 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 choose to bring legal action to enforce our intellectual property rights. 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.

We Have a Unique DSL Licensing Business Model

The success of our DSL licensing products depends upon our ability to license our technology to semiconductor and equipment companies, and our customers’ willingness and ability to sell products that incorporate our technology so that we may receive meaningful royalties that are consistent with our plans and expectations.

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;
- 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 DSL licensing business could be seriously harmed if we cannot obtain suitable customers, if our current customers cancel or put on hold DSL programs utilizing our technology, 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 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 2008 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 semiconductor manufacturers. Our ability to generate such royalties is materially affected by the willingness of equipment companies to purchase integrated circuits that incorporate our technology from our customers. 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 Business Requires Telephone Companies to Install DSL Service in Volume

The success of our DSL licensing business 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 DSL licensing business will be seriously harmed.

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

Our success in developing, introducing, selling, and supporting new and enhanced test and diagnostic 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 diagnostic 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 diagnostic products, our DSL test and diagnostic business could be seriously harmed.

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

If our test and diagnostic 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 diagnostic 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 diagnostic 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.

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;
— 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 nascent 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 contract milestones; and
— the potential that customers could fail to make payments under their contracts.

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; 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)	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
March 31, 2008, to June 30, 2008	216,991	$ 3.60	226,098	$4,180,085

(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. During 2008 and 2007, we purchased 216,991 and 9,107 shares, respectively, under this plan.

ITEM 4:
Submission of Matters to a Vote of Security Holders

On May 21, 2008, 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 Adrian F. Kruse and Edmund C. Reiter was elected to serve as a Class III director of the Company for a term expiring at the annual meeting of stockholders of the Company in 2011 or a special meeting in lieu thereof. Each of G. David Forney, Jr., John K. Kerr, Mark G. McGrath, and Michael A. Tzannes continued to serve as a director following the Annual Meeting.

The votes cast to elect the Class III directors were:

Name	For	Abstain
Adrian F. Kruse	15,382,310	701,935
Edmund C. Reiter	15,403,008	681,237

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 25, 2008	By:	/s/ Michael A. Tzannes Michael A. Tzannes, Chief Executive Officer
Date: July 25, 2008	By:	/s/ Richard P. Moberg Richard P. Moberg, Chief Financial Officer (Principal Financial and Accounting Officer)