

AWARE INC /MA/  
Form 10-K  
February 18, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of The  
Securities Exchange Act of 1934

For the fiscal year ended December 31, 2013

Commission file number 000-21129

AWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Massachusetts

(State or Other Jurisdiction of  
Incorporation or Organization)

04-2911026

(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)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class                     | Name of Each Exchange on Which Registered |
|---|---|
| Common Stock, par value \$.01 per share | The Nasdaq Global Market                  |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes o No x

Indicate by check mark 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

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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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

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

As of June 30, 2013 the aggregate market value of the registrant's common stock held by non-affiliates of the registrant, based on the closing sale price as reported on the Nasdaq Global Market, was approximately \$66,554,082.

The number of shares outstanding of the registrant's common stock as of February 7, 2014 was 22,624,375

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be delivered to shareholders in connection with the registrant's Annual Meeting of Shareholders to be held on May 21, 2014 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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AWARE, INC.  
FORM 10-K  
FOR THE YEAR ENDED DECEMBER 31, 2013

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## PART I

### FORWARD LOOKING STATEMENTS

Matters discussed in this Annual Report on Form 10-K relating to future events or our future performance, including any discussion, express or implied, of our anticipated growth, operating results, future earnings per share, market opportunity, plans and objectives, are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are often identified by the words “may,” “will,” “expect,” “believe,” “anticipate,” “intend,” “could,” “estimate,” or “continue,” expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors,” set forth in Item 1A of this Annual Report on Form 10-K and elsewhere in this Report. The forward-looking statements in this Annual Report on Form 10-K represent our views as of the date of this Annual Report on Form 10-K. We anticipate that subsequent events and developments will cause our views to change. However, while we may elect to update these forward-looking statements at some point in the future, we have no current intention of doing so except to the extent required by applicable law. You should, therefore, not rely on these forward-looking statements as representing our views as of any date subsequent to the date of this Annual Report on Form 10-K.

### ITEM 1. BUSINESS

#### Company Overview

Aware, Inc. (“Aware”, “we”, “us”, “our”, or the “Company”) is a leading provider of software and services to the biometric industry. We have been engaged in this business since 1993. Our software products are used in government and commercial biometrics systems, which are capable of determining or verifying an individual’s identity. The principal applications of biometrics systems include border control, law enforcement, national defense, secure credentialing, access control and background checks.

Our products provide interoperable, standards-compliant, field-proven biometric functionality and are used to capture, verify, format, compress and decompress biometric images as well as aggregate, analyze, process and transport those images within biometric systems. We sell a broad range of software products for fingerprint, facial, and iris modalities. We also offer engineering services related to software customization, integration, and installation, as well as complete systems development. We sell our biometrics software products and services globally through systems integrators, OEMs, and directly to end user customers.

Aware was incorporated in Massachusetts in 1986. We are headquartered at 40 Middlesex Turnpike in Bedford, Massachusetts, and our telephone number at this address is (781) 276-4000. Our website address is [www.aware.com](http://www.aware.com). The information on our website is not part of this Form 10-K, unless expressly noted. Our stock is traded on the Nasdaq Global Market under the symbol AWRE.

#### Industry Background

Biometrics is the measurement of unique, individual physiological characteristics, such as fingerprints, faces, irises, and voices, that can be used to determine or verify an individual’s identity. The biometrics industry offers technology that digitally captures and encodes biometric characteristics and then compares those characteristics against previously

encoded biometric data to determine or verify an individual's identity. Biometrics addresses the limitations inherent in traditional identification and authentication processes, such as paper credentials, passwords, PIN codes and magnetic access cards.

The biometrics industry provides identification solutions for a broad range of government and commercial applications. Principal government biometrics applications include border control, law enforcement, national defense, secure credentialing, access control and background checks. Principal commercial applications include access control for mobile devices, computers, computer networks, and buildings, as well as pre-employment background checks.

We believe that government and commercial entities will continue to adopt and expand the use of biometric-enabled solutions to address the limitations and vulnerabilities of traditional identification processes. We believe the following factors, among others, will contribute to the growth of biometrics solutions: i) government-mandated implementation of identification for employees, citizens, and foreign nationals to enhance national security; ii) military implementations for the identification of terrorists and other hostile persons; iii) increasing threats to personal security encountered in areas such as transportation; iv) government and commercial efforts to detect and reduce fraud, and v) the emergence and adoption of international biometrics standards.

The biometrics industry may be segmented into government and commercial sub-markets. While these markets are similar in many respects and share similar characteristics, other aspects of the markets are different. Important factors that differentiate the government market from the commercial market include: i) principal applications; ii) solutions; and iii) suppliers. We believe that this market-based distinction is important to an understanding of Aware's business as over 80% of our revenue is derived from government customers.

#### Government market

Governments were early adopters of biometrics technology and currently represent the largest consumer of the technology. There are sub-sectors within government, such as state, local and national, that use biometric technology. For example, at the local law enforcement level, biometric technology permits more efficient criminal booking and processing and also allows officers in the field to identify potential suspects more reliably and efficiently. Within military organizations, two key applications of biometrics involve: i) the verification and identification of military personnel and contractors; and ii) the collection and processing of biometrics from non-military personnel for the purpose of identifying potential hostile persons. State and local governments also benefit through applications such as background checks, the provision of drivers' licenses and identification cards and benefits issuance.

At the national level, governments throughout the world have taken steps to improve security in response to heightened concerns over public safety from the threat of terrorism. National governments have mandated increased spending on security measures, implemented new regulations and placed greater emphasis on technology to address growing security concerns. For example, the U.S. Office of Biometric Identity Management currently requires foreign visitors entering the United States to have their two index fingers scanned and a digital photograph taken to establish and verify their identity. The European Union now mandates that e-passports include fingerprint data in addition to a digital photograph. The biometrics industry continues to benefit from these measures because biometric technology provides a reliable means of establishing and verifying identities.

Government biometrics systems typically operate on client/server-based computer networks. Enrollment workstations with peripheral capture devices are used to "enroll" individuals into biometrics systems. Either fixed enrollment workstations or mobile devices are used to capture, process, and format biometric images. Those images are then transported in digital form to centralized matching systems for identification. Examples of capture peripherals include scanners for fingerprint images, cameras for iris and facial images, and handheld devices for mobile capture of fingerprint, iris, and facial images. Other hardware components used in biometrics systems include computer servers to process and transport biometrics images and mainframe computers and servers to store and match those images. In addition, military applications may employ handheld devices that are capable of capturing images and matching those images against image databases that reside on the devices.

Due to the nature of government applications, particularly those involving security, government biometric systems must be capable of accurately and rapidly matching biometric images against large databases of stored images. The ability to accurately and rapidly match images against databases of millions of images is critical because incorrect or

delayed results could have severe adverse consequences. These requirements are an important distinguishing characteristic of the government market as compared to the commercial market.

There are a number of vendors that serve the government biometrics market. We believe these vendors may be segmented into three types of suppliers:

i) Technology suppliers – Within this category, there are suppliers that provide software and hardware technologies that enable biometrics systems.

Biometrics software products provide functionality that: i) captures and formats images; ii) processes and transports images, and iii) matches images. Companies that sell products in this category include: i) Aware; ii) Cognitec Systems GmbH; iii) Neurotechnology; iv) Iritech, Inc.; v) Innovatrics s.r.o.; vi) WCC Group B.V.; vii) Daon, Inc.; and viii) M2Sys Technology (“M2Sys”).



Hardware companies that provide equipment used in biometrics systems includes biometrics-specific vendors, such as Cross Match Technologies, Inc., and Iris ID Systems, Inc., and companies that provide generic computer workstations and computers, such as Hewlett-Packard Development Company, L.P. and Dell, Inc.

ii) System integrators – This category of suppliers includes companies that provide system integration services. System integrators purchase hardware and software from biometrics technology vendors, such as those listed immediately above. They then incorporate those components into customized biometrics systems that they build for their end-user customers.

Examples of systems integrators include: i) Northrop Grumman Corporation; ii) Lockheed Martin Corporation; iii) Science Applications International Corporation; iv) Hewlett-Packard Enterprise Services; v) International Business Machines; vi) Fujitsu Limited; vii) Computer Science Corporation; viii) Accenture plc; ix) Raytheon Company; and x) Unisys Corporation.

iii) Fully integrated solutions vendors – This category of suppliers includes companies that are fully integrated providers of biometric systems. Such companies combine their in-house hardware and software technologies with their systems integration services to deliver customized biometrics systems to their end-user customers. While these vendors may purchase some components from third parties, we believe such component purchases represent a minor portion of the total systems they deliver.

We believe there are three primary fully integrated solutions vendors. They are: i) MorphoTrak and MorphoTrust, divisions of the Safran Group Company (“Safran Morpho”); ii) 3M Cogent Inc. (“3M/Cogent”); and iii) NEC Corporation. We believe that these companies supply a large percentage of the government market.

#### Commercial market

Commercial users have adopted biometric solutions to solve identity management problems involving the protection of sensitive information, the monitoring of access to secure areas, and the protection of personal information from identity theft. Therefore, principal commercial applications include; i) access control for mobile devices, computers, and computer networks, ii) physical access control to buildings, and iii) pre-employment background checks. The commercial market also encompasses specific solutions for certain industries, such as financial services, retail, gaming, healthcare, and educational testing.

Today, we believe a large portion of the commercial market involves authentication for access control. In this application, biometrics software is typically mated to cards, tokens, reader modules, scanners, smart phones, door locks, and cabinets, such as drug cabinets. The requirements for biometrics matching in these applications are not as robust as in the government market. Many of these applications employ 1-to-1 image matching or 1-to-few image matching. Accordingly, the biometrics technology content in commercial products is generally not as high as in government biometrics systems.

Examples of hardware and software vendors that provide products for the commercial biometrics market in addition to Aware include:

Hardware, scanner, and integrated solutions companies, such as: i) DigitalPersona, Inc.; ii) Bioscrypt, Inc., a division of Safran Morpho; iii) Suprema, Inc.; iv) 3M/Cogent; and v) Eyelock, Inc.

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Software platform companies, such as: i) M2Sys; ii) BIO-key International, Inc.; iii) Imprivata, Inc; and iv) Facebanx, a subsidiary of OhHi, Ltd.

Access control companies, such as: i) Honeywell International, Inc.; ii) HID Global Corporation; iii) Tyco International Ltd.; iv) Lenel Systems International Inc.; v) Stanley Security Limited; vi) IrisGuard, Inc.; and vii) Aurora Biometrics, Inc.; and

Smart phone companies, such as Apple, Inc. through its acquisition of AuthenTec, Inc.

Products and Services

Software products

We supply a broad range of biometrics software products for fingerprint, facial, and iris modalities. Our products capture, verify, format, compress and decompress biometric images as well as aggregate, analyze, process and transport those images within biometric systems. We also sell software maintenance contracts along with our software products. Software maintenance allows customers to receive: i) technical support; and ii) software updates, if and when they are available.

We have four categories of biometrics software products that range from discrete software blocks that customers can use to develop their own solutions to more complete applications that customers can use to reduce or eliminate their development times. Once customers sell systems that make use of these software products, they pay us software license fees based on the number of systems they use.

The four categories of our biometrics software products are described below:

i) Software Development Kits. Software development kits or (“SDKs”) consist of multiple software libraries, sample applications that show customers how to use the libraries, and documentation. Customers use our SDKs to design their own applications using our libraries. We consider these products to be commercial off-the-shelf (“COTS”) products because they are ready-made products not customized by us for any particular customer. Our SDK products and the functions they perform are:

Products for hardware abstraction, autocapture, and quality assurance:

- a) FastCapture with LiveScan API;
- b) PreFace™ with Camera API;
- c) IrisCheck™ with IrisCam API;
- d) SequenceCheck™; and
- e) Quality Check™.

Products for biometric data formatting, validation and reading according to ANSI/NIST, ISO/IEC, INCITS, ICAO, FIPS 201, and other U.S. and international standards:

- a) NISTPack;
- b) ICAOPack;
- c) PIVPack™; and
- d) M1Pack.

Products for compression and decompression of fingerprint, facial, and iris images:

- a) Aware WSQ; and
- b) Aware JPEG2000.

Products for biometric authentication:

- a) AwareXMTM

Products for scanning and printing of fingerprint cards:

- a) AccuScan™; and
- b) AccuPrint™.

Products for mobile devices:

- a) NISTPack Mobile
- b) ICAOPack Mobile
- c) PIVPack™ Mobile; and

d) AwareXMTM Mobile.

Bundles of products for specific applications:

- a) CaptureSuiteTM - for capture of either live scan or card scan fingerprint images;
- b) PIVSuiteTM – for registration, identity proofing, and ID card personalization, issuance, and reading; and
- c) ICAOSuiteTM - for biometric and biographic enrollment, e-passport personalization and reading, and fingerprint verification.

ii) Software components. Our software component products each include a user interface and one or more software libraries that perform a discrete set of functions. Software components allow customers to develop biometric applications more quickly than using our SDKs. Our set of products in this category is called BioComponentsTM. BioComponents comprises modular, independent, self-contained software components that can operate either independently or in concert with each other performing a specific biometric task. Each biometric capture component has its own configurable user interface, and performs all tasks and workflows required for capture, hardware abstraction, and quality assurance.

iii) Biometric applications. Our products in this category combine a user interface with multiple Aware software libraries into more complete biometrics applications. Our application products and the functions they perform are:

Universal Registration Client (“URC”)™. URC is a configurable Windows-based application that performs a variety of biometric data capture, analysis, matching, formatting, and hardware abstraction functions.

URC Mobile. URC Mobile is a software application for performing biometric enrollment, identification, and screening on mobile biometric devices, such as those used by military personnel in the field.

FormScannerSE and FormScannerMB. These are two independent applications for scanning and processing of inked fingerprint cards.

FormScannerSWFT. This product is a version of FormScannerSE that is preconfigured for use in compliance with the “Secure Web Fingerprint Transmission” program of the U.S. Department of Defense.

Forensic Workbench. Forensic Workbench is a software application for the categorization, processing, and standards-compliant formatting of biometric images and demographic data.

WebEnroll. WebEnroll provides a reference application with applets for browser-based enrollment of biographic data, fingerprints, and facial images.

iv) Server-based solutions. Our product in this category is called Biometrics Services Platform or BioSPTM. This product is used to build and deploy server-based biometric data processing and workflow solutions. BioSP supports the collection of biometric images from a distributed network, and the subsequent aggregation, analysis, processing and integration of this data into larger systems.

In addition to our biometrics software products, we also sell products used in applications involving medical and advanced imaging. Our principal imaging product is Aware JPEG 2000. Our JPEG 2000 image compression software may be used for a variety of applications where compression and decompression of still imagery is required.

#### Services

We offer engineering services to our customers. The service projects for which we are engaged generally fall into two principal categories:

i) Systems integrator services – this category of services includes engineering services we provide to our systems integrator customers for assistance with biometrics systems they are developing for their customers. Such services may include software customization, integration, installation, or engineering problem solving.

ii) Direct government services - this category of services arises when government customers contract directly with us for services products involving the development of complete biometrics systems, software development, and engineering problem solving.

#### Hardware products

From 2008 until early 2013, we developed a biometrics software system for a U.S. government customer under a Small Business Innovation Research (“SBIR”) contract. When the software development service project ended in February 2013, we entered into a separate contract to supply hardware products incorporating the developed software as an accommodation to this customer. Hardware products sold to this customer integrate hardware purchased from third parties with software from other third parties as well as software from Aware. We commenced shipments of equipment under this contract in May 2013. While other customers could theoretically purchase the hardware products developed for this customer, we believe that it is unlikely that they will do so, because of the highly

customized nature of the products.

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## Sales and Marketing

As of December 31, 2013, we had a total of 10 employees in our sales and marketing organization. In addition to our employee sales staff, we also engage third party sales agents to represent our products in various foreign countries.

We sell our products and services through three principal channels of distribution:

- i) Systems integrator channel – we sell to systems integrators that incorporate our software products into biometrics systems that are delivered primarily to government end users.
- ii) OEM channel – we sell to hardware and software solution providers that incorporate our software products into their products.
- iii) Direct channel – we also sell directly to government, and, to a lesser degree, to commercial customers.

Revenue from the U.S. Navy represented 21%, 5%, and 10% of total revenue during 2013, 2012, and 2011, respectively. No other customer represented 10% or more of total revenue in any of those years. All of our revenue in 2013, 2012, and 2011 was derived from unaffiliated customers.

## Competition

The markets for our products and services are competitive and uncertain. We compete against: i) other companies that provide biometric software solutions; and ii) fully diversified companies that provide biometric software solutions and also act as systems integrators. We can give no assurance that: i) our products and services will succeed in the market; ii) that we will be able to compete effectively; or iii) that competitive pressures will not seriously harm our business.

Many of our competitors are larger than us and have significantly greater financial, technological, marketing and personnel resources than we do. At the other end of the competitive spectrum, we have seen increasing competition from smaller biometrics companies in foreign countries. These smaller foreign competitors have demonstrated a willingness to sell their biometrics software products at low prices.

We can give no assurance that our customers will continue to purchase products from us or that we will be able to compete effectively in obtaining new customers to maintain or grow our business.

## Aware's Strategy

Our strategy is to capitalize on our strong brand and reputation to sell biometrics software products and services into government and commercial markets. We intend to offer a broad portfolio of high quality products that are coupled with expert technical support and services. We expect to continue to employ a three-pronged distribution strategy using systems integrators, OEMs, and direct sales.

Our strategy for growing our biometrics business may include one or more of the following elements:

- i) Product line expansion – We intend to introduce new products that will allow us to sell more software into biometrics systems and projects. Our preference is to develop new products internally by adding resources to our existing engineering staff. To the extent we are unable to develop critical new technologies internally, we may purchase or license such technologies from third parties. Alternatively, we may also acquire biometrics companies

provided we believe the acquisition cost is reasonable relative to the estimated future revenue and profits the acquired company may produce.

- ii) Geographic expansion – We believe that there are growth opportunities for biometrics projects outside of the United States. We intend to pursue foreign markets through additions to our sales staff, as well as through the use of third party sales agents.
- iii) Grow services revenue – We believe that services represent a significant portion of the total biometrics market. We further believe we can grow our services revenue by offering customers high quality engineering services that are delivered responsively at attractive prices. Our services business may benefit from past successes on services projects with other customers.



iv) Commercial market expansion – Historically our revenue has been primarily derived from government biometrics markets. Given the nature of the product solutions required in that market, we have been able to forge a profitable business model. It has been less obvious to us how we replicate that profitable model in commercial markets. As commercial markets grow and product solutions become more complex, we intend to identify opportunities where we can participate profitably.

As we attempt to grow our biometrics business, we may make investments in growth initiatives, such as those described above, that may cause our profitability to decline in the near term.

Our strategy does not include growing biometrics hardware revenue. Hardware sales in 2013 financial results are there as an accommodation to an important customer. While we expect that we will have more hardware sales in 2014, our strategy does not include deliberately trying to grow such sales.

#### Backlog

We generally deliver customer orders as we receive them, and, therefore, have no meaningful backlog of customer orders. We had an atypical backlog situation at the end of 2013 with two direct government customers. As of December 31, 2013, total backlog with these customers was \$5.0 million, including \$2.7 of hardware sales and \$2.3 of services. This backlog is scheduled for delivery during 2014. We are unable to predict whether we will have any significant backlog in future periods.

#### Research and Development

Our research and development activities are focused on enhancing our existing products and developing new products. Our engineering organization is based in Bedford, Massachusetts. As of December 31, 2013, we had an engineering staff of 37 employees, representing 64% of our total employee staff.

During the years ended December 31, 2013, 2012, and 2011, research and development expenses totaled \$4.1 million, \$3.5 million, and \$3.2 million, respectively. We expect that we will continue to invest substantial funds in research and development activities.

#### Patents and Intellectual Property

We rely on a combination of nondisclosure agreements and other contractual provisions, as well as patent, trademark, trade secret and copyright law to protect our proprietary rights. We have an active program to protect our proprietary technology through the filing of patents. As of December 31, 2013, we had approximately 124 U.S. and foreign patents, and approximately 79 pending patent applications pertaining to biometrics imaging, medical imaging compression as well as DSL service assurance.

Although we have patented certain aspects of our technology, we rely primarily on trade secrets to protect our intellectual property. We attempt to protect our trade secrets and other proprietary information through agreements with our customers, suppliers, employees and consultants, and through security measures. Each of our employees is required to sign a non-disclosure and non-competition agreement. Although we intend to protect our rights vigorously, we cannot assure you that these measures will be successful. In addition, effective intellectual property protection may be unavailable or limited in certain foreign countries.

Third parties may assert exclusive patent, copyright and other intellectual property rights to technologies that are important to us. From time to time, we receive claims from third parties suggesting that we may be obligated to license such intellectual property rights. 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.

### Manufacturing & Systems Integration

We do not design or manufacture hardware products, however we provide systems integration services for one U.S. government customer. Our systems integration activities include: i) procuring hardware and software components from third party suppliers; ii) installing Aware and third party software on the purchased hardware; and iii) testing products for quality assurance prior to shipment.

We rely on single source suppliers for certain critical hardware and software components. Our dependence on single source suppliers involves several risks, including limited control over availability, quality, and delivery schedules. Any delays in delivery or shortages of such components could cause delays in the shipment of our products, which could harm our business.

### Employees

At December 31, 2013, we employed 58 people, including 37 in engineering, 10 in sales and marketing, and 11 in finance and administration. Of these employees, 56 were based in Massachusetts. None of our employees are represented by a labor union. We consider our employee relations to be good.

We believe that our future success will depend in large part on the service of our technical, sales, marketing and senior management personnel and upon our ability to retain highly qualified technical, sales and marketing and managerial personnel. We cannot assure you that we will be able to retain our key managers and employees or that we will be able to attract and retain additional highly qualified personnel in the future.

### Discontinuation of DSL Operations

From the early 1990s until 2013, we operated up to three product lines within the Digital Subscriber Line (“DSL”) industry. Those product lines included: i) DSL silicon intellectual property that we licensed to semiconductor companies; ii) DSL service assurance hardware products that we sold to DSL test equipment companies; and iii) DSL service assurance software products that we licensed to telephone companies and DSL test equipment companies.

As of the end of 2013, we no longer operated any of these DSL product lines. The following summary describes our exit from the DSL business.

Year ended December 31, 2013. In August 2013, our Board of Directors approved the shutdown of our DSL service assurance software product line. We completed the shutdown in 2013, and results for this product line were reported in discontinued operations in our consolidated statements of income and comprehensive income for the three years ended December 31, 2013. This product line was previously a component of our DSL Service Assurance Segment.

Year ended December 31, 2012. In January 2012, our Board of Directors approved the shutdown of our DSL service assurance hardware product line. We completed the shutdown in 2012, and results for this product line were reported in discontinued operations in our consolidated statements of income and comprehensive income for the three years ended December 31, 2013. This product line was previously a component of our DSL Service Assurance Segment.

Year ended December 31, 2009. In November 2009, we sold our DSL semiconductor intellectual property business to one of our customers. The results from the last year of its operations and a gain on the sale of the business were reported in our financial results for 2009.

Notwithstanding the sale of the DSL semiconductor business, we continue to receive royalties from two customers that use our intellectual property in their DSL chipsets. The receipt of DSL royalties is the last remnant of our involvement in the DSL business, and represents a passive business activity as we have no employees or operations dedicated to the generation and/or continuation of that revenue. We simply receive royalty payments from these customers. DSL royalties are reported on a separate line of our consolidated statements of income and comprehensive income called "Royalties." Royalties declined significantly in 2013 and represented slightly less than 5% of total revenue. We expect royalties to continue to decline in future periods.

### Segment Information; Financial Information About Geographic Areas

After the shutdown of our DSL Service Assurance Segment in 2013, we organize ourselves into a single segment that reports to the chief operating decision makers. A summary of our revenue by geographic area is set forth in Note 10 to our consolidated financial statements included elsewhere in this Annual Report.

### Available Information

Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy statements, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on or through our website at [www.aware.com](http://www.aware.com) as soon as reasonably practicable after such reports are filed with, or furnished to, the Securities and Exchange Commission (the SEC). The SEC also maintains a website, [www.sec.gov](http://www.sec.gov), that contains reports and other information regarding issuers that file electronically with the SEC. Such reports, proxy statements, and other information may also be obtained by visiting the Public Reference Room of the SEC at 100 F Street, N.E., Washington, DC, 20549 or by calling the SEC at 1-800-SEC-0330.

Copies of our (i) Corporate Governance Principles, (ii) charters for the Audit Committee, Compensation Committee, and Nominating Committee, and (iii) Code of Ethics are available in the Investor Relations section of our website at [www.aware.com](http://www.aware.com).

## ITEM 1A. RISK FACTORS

Our operating results may fluctuate significantly from period-to-period and are difficult to predict.

Individual orders can represent a meaningful percentage of our revenues and net income in any single quarter and the timing of the receipt of those orders is difficult to predict. The failure to close an order or the deferral or cancellation of an order can result in revenue and net income shortfalls for that quarter. We base our current and future expense levels on our internal operating plans and sales forecasts, and our operating costs are to a large extent fixed. As a result, we may not be able to sufficiently reduce our costs in any quarter to adequately compensate for an unexpected near-term shortfall in revenues, and even a small shortfall could disproportionately and adversely affect financial results for that quarter.

Our financial results may be negatively affected by a number of factors, including the following:

the lack or reduction of government funding and the political, budgetary and purchasing constraints of government customers who purchase products and services directly or indirectly from us;

the terms of customer contracts that affect the timing of revenue recognition;

the size and timing of our receipt of customer orders;

significant fluctuations in demand for our products and services;

the loss of a key customer or one of its key customers;

new competitors, or the introduction of enhanced solutions from new or existing competitors;

competitive pressures on selling prices;

cancellations, delays or contract amendments by government customers;

higher than expected costs, asset write-offs, and other one-time financial charges; 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 derive a significant portion of our revenue directly or indirectly from government customers, and our business may be adversely affected by changes in the contracting or fiscal policies of those governmental entities.

We derive a significant portion of our revenue directly or indirectly from federal, international, state and local governments. We believe that the success and growth of our business will continue to depend on government customers purchasing our products and services either directly through us or indirectly through our channel partners. Changes in government contracting policies or government budgetary constraints may adversely affect our financial performance. Among the factors that could adversely affect our business are:

changes in fiscal policies or decreases in available government funding,

changes in government funding priorities;

changes in government programs or applicable requirements;

the adoption of new laws or regulations or changes to existing laws or regulations;

changes in political or social attitudes with respect to security and defense issues;

changes in audit policies and procedures of government entities;

potential delays or changes in the government appropriations process; and

delays in the payment of our invoices by government payment offices.

These and other factors could cause government customers or our channel partners to reduce purchases of products and services from us which would have a material adverse effect on our business, financial condition and operating results.

We derive a significant portion of our revenue from third party channel partners.

Our future results depend upon the continued successful distribution of our products through a channel of systems integrators and OEM partners. Systems integrators, including value added resellers, use our software products as a component of the biometrics systems they deliver to their customers. OEMs embed our software products in their technology devices or software products. These channel partners typically sell their products and services to government customers.

Our failure to effectively manage our relationships with these third parties could impair the success of our sales, marketing and support activities. Moreover, the activities of these third parties are not within our direct control. The occurrence of any of the following events could have a material adverse effect on our business, financial condition and operating results:

- a reduction in sales efforts by our partners;
- the failure of our partners to win government awards in which our products are used;
- a reduction in technical capabilities or financial viability of our partners;
- a misalignment of interest between us and them;
- the termination of our relationship with a major systems integrator or OEM; or
- any adverse effect on a partner's business related to competition, pricing and other factors.

If the biometrics market does not experience significant growth or if our products do not achieve broad acceptance both domestically and internationally, we may not be able to grow our business.

Our revenues are derived primarily from sales of biometrics products and services. We cannot accurately predict the future growth rate or the size of the biometrics market. The expansion of the biometrics market and the market for our biometrics products and services depend on a number of factors, such as:

- the cost, performance and reliability of our products and services and the products and services offered by our competitors;
- the continued growth in demand for biometrics solutions within the government and law enforcement markets as well as the development and growth of demand for biometric solutions in markets outside of government and law enforcement;
- customers' perceptions regarding the benefits of biometrics solutions;
- public perceptions regarding the intrusiveness of these solutions and the manner in which organizations use the biometric information collected;
- public perceptions regarding the confidentiality of private information;
- proposed or enacted legislation related to privacy of information;
- customers' satisfaction with biometrics solutions; and
- marketing efforts and publicity regarding biometrics solutions.

Even if biometrics solutions gain wide market acceptance, our solutions may not adequately address market requirements and may not continue to gain market acceptance. If biometrics solutions generally or our solutions specifically do not gain wide market acceptance, we may not be able to achieve our anticipated level of growth and our revenues and results of operations would be adversely affected.

We face intense competition from other biometrics solutions providers.



A significant number of established companies have developed or are developing and marketing software and hardware for biometrics products and applications that currently compete with or will compete directly with our offerings. We believe that additional competitors will enter the biometrics market and become significant long-term competitors, and that, as a result, competition will increase. Companies competing with us may introduce solutions that are competitively priced, have increased performance or functionality or incorporate technological advances we have not yet developed or implemented. Our current principal competitors include:

Diversified technology providers that offer integrated biometrics solutions to governments, law enforcement agencies and other organizations. This group of competitors includes companies such as Safran Morpho, a division of the Safran Group Company; 3M Cogent, and NEC Corporation.

Component providers that offer biometrics software and hardware components for fingerprint, facial, and iris biometric identification. This group of competitors includes companies such as Cognitec Systems GmbH; Neurotechnology; Iritech, Inc.; Iris ID Systems, Inc.; Innovatrics s.r.o.; WCC Group B.V.; Daon, Inc.; and M2Sys Technology (“M2Sys”).

We expect competition to intensify in the near term in the biometrics market. Many current and potential competitors have substantially greater financial, marketing, and research resources than we have. Moreover, low cost foreign competitors from third world and other countries have demonstrated a willingness to sell their products at significantly reduced prices. To compete effectively in this environment, we must continually develop and market new and enhanced solutions and technologies at competitive prices and must have the resources available to invest in significant research and development activities. Our failure to compete successfully could cause our revenues and market share to decline.

The biometrics industry is characterized by rapid technological change and evolving industry standards, which could render our existing products obsolete.

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing products in order to address the changing and sophisticated needs of the marketplace. Frequently, technical development programs in the biometrics industry require assessments to be made of the future direction of technology, which is inherently difficult to predict. Delays in introducing new products and enhancements, the failure to choose correctly among technical alternatives or the failure to offer innovative products or enhancements at competitive prices may cause customers to forego purchases of our products and purchase our competitors’ products. We may not have adequate resources available to us or may not adequately keep pace with appropriate requirements in order to effectively compete in the marketplace.

Our software products may have errors, defects or bugs, which could result in delayed or lost revenue, expensive correction, liability to our customers, and claims against us.

Complex software products such as ours may contain errors, defects or bugs. Defects in the products that we develop and sell to our customers could require expensive corrections and result in delayed or lost revenue, adverse customer reaction and negative publicity about us or our products and services. Customers who are not satisfied with any of our products may also bring claims against us for damages, which, even if unsuccessful, would likely be time-consuming to defend, and could result in costly litigation and payment of damages. Such claims could harm our reputation, financial results and competitive position.

Our business may be adversely affected by our use of open source software.

The software industry is making increasing use of open source software in the development of products. We also license and integrate certain open source software components from third parties into our software. Open source software license agreements may require that the software code in these components or the software into which they are integrated be freely accessible under open source terms. Many features we may wish to add to our products in the future may be available as open source software and our development team may wish to make use of this software to reduce development costs and speed up the development process. While we carefully monitor the use of all open source software and try to ensure that no open source software is used in such a way as to require us to disclose the source code to the related product, such use could inadvertently occur. If we were required to make our software freely available, our business could be seriously harmed.

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. We rely on a combination of patent, trade secret, copyright, and trademark law as well as confidentiality agreements to protect our proprietary technology, and cannot assure you that we will be able to enforce the patents we own against third parties. Despite our efforts, these measures can only provide limited protection. Unauthorized third parties may try to copy or reverse engineer portions of our products or otherwise obtain and use our intellectual property. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business would thus be harmed.

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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. Accordingly, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property or otherwise gaining access to our technology. The misappropriation of our technology or the development of competitive technology could seriously harm our business.

We may be sued by third parties for alleged infringement of their proprietary rights.

Our technology and products may infringe the intellectual property rights of others. A large and increasing number of participants in the technology industry, including companies known as non-practicing entities, have applied for or obtained patents. Some of these patent holders have demonstrated a readiness to commence litigation based on allegations of patent infringement. Third parties have asserted against us in the past and may assert against us in the future patent, copyright and other intellectual property rights to technologies that are important to our business.

Intellectual property rights can be uncertain and involve complex legal and factual questions. Moreover, intellectual property claims, with or without merit, can be time-consuming and expensive to litigate or settle, and could divert management attention away from the execution of our business plan. If we were found to have infringed the proprietary rights of others, we could be subject to substantial damages or an injunction preventing us from conducting our business.

If we are unable to attract and retain key personnel, our business could be harmed.

If any of our key employees were to leave, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any successor obtains the necessary training and experience. Our employment relationships are at-will and we have had key employees leave in the past. We cannot assure you that one or more key employees will not leave in the future. We intend to continue to hire additional highly qualified personnel, including software engineers and sales personnel, but may not be able to attract, assimilate or retain qualified personnel in the future. Any failure to attract, integrate, motivate and retain these employees could harm our business.

We rely on single sources of supply for certain components used in our hardware products.

We commenced sales of biometrics hardware products to a U.S. government customer in 2013. Hardware products sold to this customer integrate hardware and software purchased from third parties. We rely on single source suppliers for certain critical hardware and software components. Our dependence on single source suppliers involves several risks, including limited control over availability, quality, and delivery schedules. Any delays in delivery or shortages of such components could cause delays in the shipment of our products, which could harm our business.

Our business may be affected by government regulations.

Extensive regulation by federal, state, and foreign regulatory agencies could adversely affect us in ways that are difficult for us to predict. In addition, our business may also be adversely affected by: i) the imposition of tariffs, duties and other import restrictions on goods and services we purchase from non-domestic suppliers; or ii) by the imposition of export restrictions on products we sell internationally. Changes in current or future laws or regulations, in the United States or elsewhere, could seriously harm our business.



Adverse economic conditions could harm our business.

Unfavorable changes in economic conditions, including recessions, inflation, turmoil in financial markets, or other changes in economic conditions, could harm our business, results of operations, and financial conditions as a result of:

reduced demand for our products;  
increased risk of order cancellations or delays;  
increased pressure on the prices for our products;  
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 timing, duration, and severity of any such 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 may make acquisitions of companies.

We may make acquisitions of companies that offer complementary products, services and technologies. Any acquisitions we may complete involve a number of risks, including the risks of assimilating the operations and personnel of acquired companies, realizing the value of the acquired assets relative to the price paid, distraction of management from our ongoing businesses and potential product disruptions associated with the sale of the acquired company's products. These factors could have a material adverse effect on our business, financial condition, operating results and cash flows. The consideration we pay for any future acquisitions could include our stock. As a result, future acquisitions could cause dilution to existing shareholders and to earnings per share.

Royalties will likely decline in future periods.

Prior to November 2009, we were a supplier of DSL silicon intellectual property to the semiconductor industry. We continue to receive royalties from two principal customers that use our DSL silicon IP in their DSL chipsets. It is difficult for us to make accurate forecasts of DSL chipset royalty revenue because such revenue depends on factors that are beyond our control. Royalty revenue from both of our licensees declined significantly in 2013. We believe it is likely that royalties will continue to decline in future periods.

The market price of our common stock has been and may continue to be subject to wide fluctuations, and this may make it difficult for shareholders to resell the common stock when they want or at prices they find attractive.

The market price of our common stock, like that of other technology companies, is volatile and is subject to wide fluctuations in response to a variety of factors, including:

quarterly variations in operating results;  
announcements of technological innovations or new products by us or our competitors,  
changes in customer relationships, such as the loss of a key customer;  
recruitment or departure of key personnel;

corporate actions we may initiate, such as acquisitions, stock sales or repurchases, dividend declarations, or corporate reorganizations; and

other events or factors.

Our stock price may also be affected by broader market trends unrelated to our performance. As a result, purchasers of our common stock may be unable at any given time to sell their shares at or above the price they paid for them. Moreover, companies that have experienced volatility in the market price of their stock often are subject to securities class action litigation. If we were the subject of such litigation, it could result in substantial costs and divert management's attention and resources.

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 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.

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 policies 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 our judgments and estimates differ from actual results, 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 accounting standards requires us to interpret and apply them appropriately. If our current interpretations or applications are later found to be incorrect, we may have to restate our financial statements and the price of our stock could decline.

#### ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.



## ITEM 2. PROPERTIES

We believe that our existing facilities are adequate for our current needs and that additional space sufficient to meet our needs for the foreseeable future will be available on reasonable terms. We currently occupy approximately 72,000 square feet of office space in Bedford, Massachusetts, which serves as our headquarters. This site is used for our research and development, sales and marketing, and administrative activities. We own this facility.

## ITEM 3. 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 4. MINE SAFETY DISCLOSURES

Not applicable.

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is the only class of stock we have outstanding, and it trades on the Nasdaq Global Market under the symbol AWRE. The following table sets forth the high and the low sales prices of our common stock as reported on the Nasdaq Global Market for the periods indicated from January 1, 2012 to December 31, 2013.

|      | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|------|------------------|-------------------|------------------|-------------------|
| 2013 |                  |                   |                  |                   |
| High | \$ 6.25          | \$ 5.65           | \$ 5.64          | \$ 6.14           |
| Low  | 4.58             | 4.50              | 4.80             | 5.06              |
| 2012 |                  |                   |                  |                   |
| High | \$ 4.68          | \$ 7.50           | \$ 6.88          | \$ 6.90           |
| Low  | 2.30             | 3.34              | 5.31             | 5.05              |

As of February 6, 2014, we had approximately 108 shareholders of record. This number does not include shareholders from whom shares were held in a "nominee" or "street" name. We paid no dividends in 2011 and 2013. In 2012, we paid a special cash dividend of \$1.15 per share on May 25, 2012 and another special cash dividend of \$1.80 per share on December 17, 2012. We anticipate that we will continue to reinvest any earnings to finance future operations although we may also pay additional special cash dividends if our board of directors deems it appropriate.

We did not sell any equity securities that were not registered under the Securities Act of 1933 during the three months ended December 31, 2013.

## Stock Performance Graph

The following stock performance graph compares the performance of Aware's cumulative stockholder return with that of a broad market index, the Nasdaq Composite Index, and a published industry index, the RDG Technology Composite Index. The cumulative stockholder returns for shares of Aware's common stock and for the market and industry indices are calculated assuming \$100 was invested on December 31, 2008. Aware paid no cash dividends in 2009, 2010, 2011, and 2013. In 2012, we paid special cash dividends of \$2.95 per share. The performance of the market and industry indices is shown on a total return, or dividend reinvested, basis.

## COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*

Among Aware, Inc., the NASDAQ Composite Index, and the RDG Technology Composite Index

\*\$100 invested on 12/31/08 in stock or index, including reinvestment of dividends.  
Fiscal year ending December 31.

|                             | Value of Investment (\$) |           |           |           |           |           |
|-----------------------------|--------------------------|-----------|-----------|-----------|-----------|-----------|
|                             | 12/31/08                 | 12/31/09  | 12/31/10  | 12/31/11  | 12/31/12  | 12/31/13  |
| Aware, Inc.                 | \$ 100.00                | \$ 149.73 | \$ 151.87 | \$ 160.43 | \$ 467.26 | \$ 520.97 |
| Nasdaq<br>Composite Index   | 100.00                   | 144.88    | 170.58    | 171.30    | 199.99    | 283.39    |
| RDG Technology<br>Composite | 100.00                   | 160.94    | 181.64    | 181.83    | 208.18    | 274.77    |

## ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial and operating data set forth below with respect to our consolidated financial statements for the fiscal years ended December 31, 2013, 2012 and 2011 are derived from the consolidated financial statements included elsewhere in this Form 10-K. The data for fiscal years ended December 31, 2010 and 2009 are derived from previously filed consolidated financial statements after giving effect to discontinued operations. The data set forth below should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” our historical consolidated financial statements, and the related notes to the consolidated financial statements, which can be found in Item 7 and Item 8.

| Year ended December 31,   | 2013                                  | 2012     | 2011     | 2010     | 2009     |
|---|---------------------------------------|----------|----------|----------|----------|
|   | (in thousands, except per share data) |          |          |          |          |
| <b>Statements of Comprehensive Income Data</b>                  |                                       |          |          |          |          |
| Revenue   | \$19,357                              | \$17,304 | \$16,199 | \$12,975 | \$15,856 |
| Operating income (loss) before patent related income            | 4,538                                 | 5,043    | 3,500    | (360)    | (3,834)  |
| Gain on sale of patent assets                                   | -                                     | 86,394   | -        | -        | -        |
| Gain on sale of assets  | -                                     | -        | -        | -        | 6,230    |
| Income from continuing operations, net of income taxes          | 3,752                                 | 72,383   | 3,581    | 154      | 2,629    |
| Income (loss) from discontinued operations, net of income taxes | (1,156)                               | (76)     | (1,014)  | 26       | (1,647)  |
| Net income  | 2,596                                 | 72,307   | 2,567    | 180      | 982      |
| Net income per share – basic                                    | \$0.12                                | \$3.32   | \$0.12   | \$0.01   | \$0.05   |
| Net income per share – diluted                                  | \$0.11                                | \$3.28   | \$0.12   | \$0.01   | \$0.05   |
| <b>Balance Sheet Data</b>                                       |                                       |          |          |          |          |
| Cash and cash equivalents                                       | \$72,660                              | \$71,074 | \$46,577 | \$39,949 | \$39,669 |
| Working capital   | 75,760                                | 73,358   | 48,069   | 43,818   | 42,209   |
| Total assets  | 89,329                                | 85,854   | 57,851   | 53,400   | 51,454   |
| Total liabilities   | 4,179                                 | 3,958    | 3,276    | 3,517    | 3,094    |
| Total stockholders’ equity                                      | 85,150                                | 81,896   | 54,575   | 49,883   | 48,360   |

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## RESULTS OF OPERATIONS

The following table sets forth, for the years indicated, certain line items from our consolidated statements of income and comprehensive income stated as a percentage of total revenue:

|  | Year ended December 31, |   |      |   |      |   |
|--|-------------------------|---|------|---|------|---|
|  | 2013                    |   | 2012 |   | 2011 |   |
| Revenue:   |                         |   |      |   |      |   |
| Software licenses                                      | 43                      | % | 55   | % | 48   | % |
| Software maintenance                                   | 20                      |   | 18   |   | 16   |   |
| Services   | 16                      |   | 15   |   | 23   |   |
| Hardware sales   | 16                      |   | -    |   | -    |   |
| Royalties  | 5                       |   | 12   |   | 13   |   |
| Total revenue  | 100                     |   | 100  |   | 100  |   |
| Costs and expenses:                                    |                         |   |      |   |      |   |
| Cost of hardware sales                                 | 12                      |   | -    |   | -    |   |
| Cost of services                                       | 8                       |   | 9    |   | 9    |   |
| Research and development                               | 21                      |   | 20   |   | 20   |   |
| Selling and marketing                                  | 18                      |   | 20   |   | 18   |   |
| General and administrative                             | 18                      |   | 22   |   | 31   |   |
| Total costs and expenses                               | 77                      |   | 71   |   | 78   |   |
| Operating income before patent related income          | 23                      |   | 29   |   | 22   |   |
| Gain on sale of patent assets                          | -                       |   | 499  |   | -    |   |
| Income from patent arrangement                         | 4                       |   | 7    |   | -    |   |
| Operating income after patent related income           | 27                      |   | 535  |   | 22   |   |
| Other income   | -                       |   | -    |   | -    |   |
| Interest income  | 2                       |   | 1    |   | -    |   |
| Income from continuing operations before income taxes  | 29                      |   | 536  |   | 22   |   |
| Provision for income taxes                             | 10                      |   | 118  |   | -    |   |
| Income from continuing operations                      | 19                      |   | 418  |   | 22   |   |
| Loss from discontinued operations, net of income taxes | (6                      | ) | -    |   | (6   | ) |
| Net income   | 13                      | % | 418  | % | 16   | % |

## Summary of Operations

## Continuing Operations.

We are primarily engaged in the development and sale of biometrics products and services. Our biometrics products are incorporated into biometrics systems that are used for law enforcement, border control, national defense, secure credentialing, access control and background checks. We sell our software and services to systems integrators and OEMs, as well as directly to government customers. We also derive a minor portion of our revenue from the sale of imaging software to OEMs that incorporate it into medical imaging products.

Income from continuing operations in 2012 includes gains from the sale of patent assets of \$86.4 million. There were no similar gains in 2011 or 2013.

#### Discontinued Operations.

We shut down our DSL service assurance hardware product line in 2012 and our DSL service assurance software product line in 2013. Both of these product lines were previously components of our DSL Service Assurance Segment. The results of the DSL Service Assurance Segment have been reported as discontinued operations as we no longer have any significant continuing involvement with, or cash flows from, this segment.

## Summary of Financial Results

Net income (loss) from continuing and discontinued operations for the years ended December 31, 2013, 2012 and 2011 was as follows (in thousands):

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2013                     | 2012     | 2011     |
| Income from continuing operations                      | \$3,752                  | \$72,383 | \$3,581  |
| Loss from discontinued operations, net of income taxes | (1,156 )                 | (76 )    | (1,014 ) |
| Net income   | \$2,596                  | \$72,307 | \$2,567  |

## Income from continuing operations - 2013 compared to 2012

Income from continuing operations decreased from \$72.4 million in 2012 to \$3.8 million in 2013. The decrease was primarily due to gains on the sale of patent assets in 2012, which did not recur in 2013. Operating income before patent related income provides a more meaningful measure of on-going operating results. On that basis, operating income decreased by \$0.5 million from \$5.0 million in 2012 to \$4.5 million in 2013. The \$0.5 million decrease was primarily due to lower royalty revenue that was partially offset by lower expenses related to two employees who were involved with patent monetization and who left the company in 2012.

## Income from continuing operations - 2012 compared to 2011.

Income from continuing operations increased from \$3.6 million in 2011 to \$72.4 million in 2012. The increase was primarily due to the sale of patents in 2012. Operating income before patent related income provides a more meaningful measure of on-going operating results. On that basis, operating income increased by \$1.5 million from \$3.5 million in 2011 to \$5.0 million in 2012. The \$1.5 million increase was primarily due to a combination of increased revenue and profitability in our biometrics business and lower general and administrative expenses.

## Software Licenses

Software licenses consist of revenue from the sale of biometrics and imaging software products. Sales of software products depend on our ability to win proposals to supply software for biometrics systems projects either directly to government customers or indirectly through channel partners.

Software license revenue decreased 13% from \$9.5 million in 2012 to \$8.2 million in 2013. As a percentage of total revenue, software license revenue decreased from 55% in 2012 to 43% in 2013. The dollar decrease in software license revenue was primarily due to lower sales to systems integrator and OEM customers. Software license sales to direct government customers were approximately the same in both years. We believe that lower software demand from channel partners in 2013 was primarily attributable to two factors: i) our partners won fewer new systems projects proposals involving our software in 2013; and ii) some larger projects that commenced in 2011 and 2012 wound down during 2013.

Software license revenue increased 22% from \$7.8 million in 2011 to \$9.5 million in 2012. As a percentage of total revenue, software license revenue increased from 48% in 2011 to 55% in 2012. The dollar increase in software license revenue was primarily due to the following factors: i) license purchases by legacy and new systems integrator customers for large projects in which they were engaged; ii) a large direct sale to a U.S. government agency; iii) the addition of new sales representatives; and iv) the expanded use of non-employee sales agents outside the United States.

## Software Maintenance

Software maintenance consists of revenue from the sale of software maintenance contracts. Software maintenance contracts entitle customers to receive software support and software updates, if and when they become available, during the term of the contract.

Software maintenance revenue increased 27% from \$3.0 million in 2012 to \$3.9 million in 2013. As a percentage of total revenue, software maintenance revenue increased from 18% in 2012 to 20% in 2013.



Software maintenance revenue increased 17% from \$2.6 million in 2011 to \$3.0 million in 2012. As a percentage of total revenue, software maintenance revenue increased from 16% in 2011 to 18% in 2012.

The dollar increase in software maintenance revenue in 2012 and 2013 was primarily due to a growing base of customers who use our software and who also purchase maintenance contracts on that software. A majority of our customers purchase software maintenance contracts when they initially purchase software licenses. Since our software is used in active biometrics systems, most of our customers continue to renew their maintenance contracts in subsequent years while systems remain operational. The increases in software maintenance revenue in 2012 and 2013 were primarily due to software license sales in 2011, 2012 and 2013 which drove the initial purchase of maintenance and the subsequent renewal of those contracts.

### Services

Services consist of fees we charge to perform software development, integration, installation, and customization services. Similar to software license revenue, services revenue depends on our ability to win biometrics systems projects either directly with government customers or in conjunction with channel partners. Services revenue will fluctuate when we commence new projects and/or when we complete projects that were started in previous periods.

Services increased 22% from \$2.6 million in 2012 to \$3.1 million in 2013. As a percentage of total revenue, services increased from 15% in 2012 to 16% in 2013. The dollar increase in services revenue was primarily due to a significant project with a new U.S. government customer that commenced in 2013. As of December 31, 2013, we had \$2.2 million of services revenue in backlog with this customer, which we expect to deliver in 2014. Services revenue derived from all other government customers and channel partners in 2012 and 2013 was approximately the same in both years.

Services decreased 30% from \$3.7 million in 2011 to \$2.6 million in 2012. As a percentage of total revenue, services decreased from 23% in 2011 to 15% in 2012. The dollar decrease in services revenue was primarily due to lower services revenue from two larger customers. One customer project ended in late 2011 and produced little revenue in 2012 after a significant amount of revenue in 2011. The other customer project wound down over the course of 2012 and resulted in significantly less revenue in 2012 compared to 2011 when the project was most active. Services revenue derived from all other customers in 2011 and 2012 was approximately the same in both years.

### Hardware sales

Hardware sales consist of sales of biometrics equipment to a single U.S. government customer. Over the past five years, we developed biometrics software for this customer under a Small Business Innovation Research (“SBIR”) contract. When the software development phase ended in February 2013, we entered into a separate contract to supply hardware products incorporating the developed software. Hardware products sold to this customer integrate hardware purchased from third parties with software from other third parties as well as software from Aware. We evaluated the classification of gross versus net revenue recognition and determined gross recognition was appropriate. We commenced shipments of equipment under this contract in May 2013.

Hardware sales increased from \$0 in 2012 to \$3.2 million in 2013. As a percentage of total revenue, hardware sales increased from 0% in 2012 to 16% in 2013. The dollar increase in hardware sales was due to the commencement of shipments in 2013.

There were no hardware sales in 2012 and 2011.

We are unable to predict future hardware sales with any degree of certainty because: i) our contract with the government provides pricing, but does not obligate the government to purchase any products until it provides us with purchase orders; and ii) we have minimal historical experience with which to make revenue projections. Notwithstanding the foregoing, we received an order in September 2013 for \$4.7 million of hardware products. We shipped \$2.1 million of this order in the fourth quarter of 2013, and we intend to ship the remaining \$2.6 million in the first quarter of 2014.

## Royalties

Royalties consist of royalty payments we receive under DSL silicon contracts with two customers that incorporate our silicon intellectual property (“IP”) in their DSL chipsets. We sold our DSL IP business in 2009, but we continue to receive royalty payments from these customers.

Royalties decreased 58% from \$2.2 million in 2012 to \$0.9 million in 2013. As a percentage of total revenue, royalties decreased from 12% in 2012 to 5% in 2013. The dollar decrease in royalties was primarily due to lower DSL royalties from both of our licensees. One of our licensees achieved chipset sales that exceeded certain sales thresholds in our contractual arrangement in late 2012. The achievement of those sales thresholds triggered reductions in the royalty rate it is required to pay on certain products and eliminated them altogether on other products. Our other licensee also reported lower royalties to us in 2013.

Royalties were essentially unchanged at approximately \$2.2 million in 2011 and 2012. As a percentage of total revenue, royalties decreased from 13% in 2011 to 12% in 2012. Unchanged royalty revenue reflects higher DSL royalties from one customer that were offset by lower DSL royalties from the other.

We believe it is likely that royalties will continue to decline in future quarters.

## Cost of Hardware Sales

Cost of hardware sales consists primarily of the cost of third party equipment and software included in hardware shipments.

Cost of hardware sales increased from \$0 in 2012 to \$2.4 million in 2013. Cost of hardware sales as a percentage of hardware sales were 74% in 2013, which means that gross margins on hardware sales were 26%. The dollar increase in cost of hardware sales was due to the commencement of hardware shipments in 2013.

There were no hardware sales in 2012 and 2011, therefore there was no cost of hardware sales in those years.

## Cost of Services

Cost of services consists of engineering costs to perform customer services projects. Such costs primarily include: i) engineering salaries, stock-based compensation, fringe benefits, and facilities; and ii) engineering consultants and contractors.

Cost of services was unchanged at \$1.5 million in 2012 and 2013. As a percentage of services revenue, cost of services decreased from 60% in 2012 to 48% in 2013, which resulted in gross margins on service revenue increasing from 40% to 52%.

Cost of services was unchanged at \$1.5 million in 2011 and 2012. As a percentage of services revenue, cost of services increased from 41% in 2011 to 60% in 2012, which resulted in gross margins on service revenue decreasing from 59% to 40%.

Gross services margins of 52%, 40%, and 59% in 2013, 2012 and 2011, respectively, were a function of: i) the nature of the projects; ii) the level of engineering difficulty and labor hours required to complete project tasks; and iii) how much we were able to charge. Gross margins in these years reflect the profitability mix of customer projects. We

expect that gross margins on services will continue to fluctuate in future periods based on the nature, complexity, and pricing of future projects.

#### Research and Development Expense

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

The classification of total engineering costs to research and development expense and cost of services was (in thousands):

|                                  | Years ended December 31, |          |          |
|----------------------------------|--------------------------|----------|----------|
|                                  | 2013                     | 2012     | 2011     |
| Research and development expense | \$ 4,085                 | \$ 3,489 | \$ 3,203 |
| Cost of services                 | 1,503                    | 1,542    | 1,518    |
| Total engineering costs          | \$ 5,588                 | \$ 5,031 | \$ 4,721 |

Research and development expense increased 17% from \$3.5 million in 2012 to \$4.1 million in 2013. As a percentage of total revenue, research and development expense increased from 20% in 2012 to 21% in 2013.

Research and development expense increased 9% from \$3.2 million in 2011 to \$3.5 million in 2012. As a percentage of total revenue, research and development expense was unchanged at 20% in 2011 and 2012.

The dollar increase in research and development expense in 2013 and 2012 was primarily due to headcount growth in our engineering organization. We hired additional engineers in both years to help us develop new products and enhance our existing products to enable us to participate more fully in future biometrics systems projects. The dollar increase in research and development spending in these years was partially offset by lower expenses related to a former employee who was involved with the effort to monetize patents who left the company in 2012.

We anticipate that we will continue to focus our future research and development activities on enhancing our existing products and developing new products.

#### Selling and Marketing Expense

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

Selling and marketing expense was essentially unchanged at approximately \$3.4 million in 2012 and 2013. As a percentage of total revenue, selling and marketing expense decreased from 20% in 2012 to 18% in 2013. Unchanged selling and marketing expense reflects two sets of offsetting factors. Expenses increased due to growth in our sales organization, but those increases were mostly offset by lower expenses related to a former employee who was involved with the effort to monetize patents who left the company in 2012. Expense growth in the sales organization was driven by new sales employees, foreign sales agents, and higher sales commissions.

Selling and marketing expense increased 13% from \$3.0 million in 2011 to \$3.4 million in 2012. As a percentage of total revenue, selling and marketing expense increased from 18% in 2011 to 20% in 2012. The dollar increase in selling and marketing expense was primarily due to higher spending on new sales employees, foreign sales agents and sales commissions.

#### General and Administrative Expense

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

such as insurance costs and bad debt provisions.

General and administrative expense decreased 9% from \$3.9 million in 2012 to \$3.5 million in 2013. As a percentage of total revenue, general and administrative expense decreased from 22% in 2012 to 18% in 2013. The dollar decrease in general and administrative expense was primarily due to two sets of offsetting factors. Expenses decreased due to lower: i) patent prosecution legal fees; ii) audit fees; and iii) general corporate legal fees. Such expense reductions were partially offset by stock-based compensation costs associated with a stock grant to directors and officers in April 2013.

General and administrative expense decreased 23% from \$5.0 million in 2011 to \$3.9 million in 2012. As a percentage of total revenue, general and administrative expense decreased from 31% in 2011 to 22% in 2012. The dollar decrease in general and administrative expense was primarily due to: i) \$0.8 million of lower salary, severance, stock-based compensation and consulting expenses related to our former CEO; ii) \$0.5 million of lower expenses related to our former Chairman whose expenses were classified as sales and marketing expense commencing in the fourth quarter of 2011 when his title and role changed; and iii) and \$0.1 million of lower stock-based compensation expenses for other members of senior management and our administrative staff. Lower general and administrative expenses related to these three factors were partially offset by: i) \$0.2 million of higher third party accounting fees to assist us with the tax accounting on gains on patent asset sales; and ii) \$0.1 million of higher other administrative expenses.

#### Gain on Sale of Patent Assets

In 2011, we engaged an intellectual property law firm to help us conduct a process to sell a portion of our patent portfolio pertaining to wireless and certain DSL patents. The process produced two significant patent sales for a total of \$86.4 million of net gains in 2012. The two patent sales are described below:

On April 26, 2012, we entered into an agreement with an unaffiliated third party to sell a portion of our patent portfolio pertaining to wireless technology for \$75.0 million. The proceeds from the sale were reduced by \$3.8 million of transaction costs, which consisted primarily of fees from the law firm that assisted us in the sale. The transaction closed on June 21, 2012 and resulted in a gain of \$71.2 million.

On August 22, 2012, we entered into an agreement with an unaffiliated third party to sell a portion of our patent portfolio pertaining to digital subscriber line (“DSL”) technology for \$16.0 million. The proceeds from the sale were reduced by \$0.8 million of transaction costs, which also consisted primarily of fees from the law firm that assisted us in the sale. The transaction closed on September 21, 2012 and resulted in a gain of \$15.2 million.

#### Income from Patent Arrangement

In December 2010, we entered into an arrangement with an unaffiliated third party under which we assigned certain patents in return for royalties on proceeds from patent monetization efforts by the third party.

In 2012 and 2013, we recorded income from this entity of \$1.1 million and \$0.8 million, respectively.

We are unable to predict how much more income we might receive from this arrangement, if any, because we do not know whether any patent monetization efforts by the third party will be successful.

#### Other Income

We recorded \$85,000 and \$23,000 of other income in the years ended December 31, 2012 and 2013, respectively. These amounts represented realized gains from sales or calls of high yield bond investments.

#### Interest Income

Interest income increased 44%, or \$101,000, from \$227,000 in 2012 to \$328,000 in 2013. The dollar increase was primarily due to interest income from high yield bonds as we held more bonds in 2013 than 2012.

Interest income increased 175%, or \$144,000, from \$83,000 in 2011 to \$227,000 in 2012. The dollar increase was primarily due to: i) interest income from high yield bonds; and ii) higher cash balances as a result of the patent sales in 2012.



## Income Taxes

We are subject to income taxes in the United States and we use estimates in determining our provisions for income taxes. We account for income taxes using the asset and liability method for accounting and reporting income taxes. Deferred tax assets and liabilities are recognized based on temporary differences between the financial reporting and income tax bases of assets and liabilities using statutory rates.

A discussion of income taxes for the years ended December 31, 2013, 2012, and 2011 follows:

### Year ended December 31, 2013

Total income tax expense for the year ended December 31, 2013 was \$1.2 million, including \$1.9 million that was recorded in continuing operations less a tax benefit of \$0.7 million that was recorded in discontinued operations. Income tax expense for 2013 was based on the U.S. statutory rate of 34%, increased by state income taxes. Tax expense in 2013 also reflects two items related to 2012, including:

- a tax benefit of \$95,000 related to the 2012 research tax credit. This credit was extended retroactively back to January 1, 2012, by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013; and

- a tax benefit of \$148,000 related to a reduction in the estimate of the 2012 tax expense recorded in our 2012 financial statements.

As of December 31, 2013, we had a total of \$1.1 million of deferred tax assets for which we had recorded no valuation allowance. We will continue to assess the level of valuation allowance in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

In addition to deferred tax assets carried on our balance sheet, we also had net federal and state research and development credit carryforwards available at December 31, 2013 of \$4.9 million and \$0.7 million. These credits were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets can be used to reduce taxes, the benefit must be recorded as a reduction to additional paid-in capital. In 2013, we recorded a tax benefit of \$128,000 to equity related to the use of these tax credits to reduce our tax liability.

### Year ended December 31, 2012

Total income tax expense for the year ended December 31, 2012 was \$20.4 million, including \$20.5 million that was recorded in continuing operations less a tax benefit of \$51,000 that was recorded in discontinued operations. The Company's actual tax liability for 2012 was \$7.8 million as taxes that were currently payable were reduced by a \$14.4 million equity adjustment. This equity adjustment is described more fully below.

In 2012, we used a significant portion of our available deferred tax assets to reduce income taxes on pre-tax income. A substantial portion of the deferred tax assets we utilized comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, the portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. In the year ended December 31, 2012, the tax benefits from such stock-based awards were \$14.4 million, which we recorded as an equity adjustment to additional paid-in capital.

Income tax expense in 2012 was also reduced by a \$1.8 million reversal of the valuation allowance on our remaining deferred tax assets at December 31, 2012. We reversed the valuation allowance because based on all the available evidence, we believed that it is more likely than not that our deferred tax assets will be realizable. In reaching this determination, we evaluated: i) our most recent years operating results; ii) our future financial plans; and iii) the nature of the components comprising deferred tax assets at December 31, 2012.

Year ended December 31, 2011

Total income tax expense for the year ended December 31, 2011 was \$2,000, all of which was recorded in continuing operations. Income tax expense in 2011 comprised state excise taxes as we had net operating losses for federal and state income tax purposes.

Loss from discontinued operation, net of income taxes.

Loss from discontinued operations, net of income taxes reflects results from our discontinued DSL Service Assurance Segment. This segment includes results from our DSL hardware and software product lines that we shut down in 2012 and 2013, respectively. Loss from such discontinued operations was (in thousands):

|                                   | Years ended December 31, |          |             |
|-----------------------------------|--------------------------|----------|-------------|
|                                   | 2013                     | 2012     | 2011        |
| Revenue                           | \$ 3,216                 | \$ 5,431 | \$ 8,387    |
| Expenses                          | 5,120                    | 5,558    | 9,401       |
| Loss before income taxes          | (1,904 )                 | (127 )   | (1,014 )    |
| Income tax benefit                | (748 )                   | (51 )    | -           |
| Loss from discontinued operations | (\$ 1,156 )              | (\$ 76 ) | (\$ 1,014 ) |

## LIQUIDITY AND CAPITAL RESOURCES

In recent years, we have financed the company with our cash balances, cash generated from operations, and cash received from the sale of patent assets. Equity financing has not been a meaningful source of financing for us in recent years. Cash flows from operating, investing and financing activities are described below.

### Cash flow from operating activities

In the years ended December 31, 2013 and 2011, our operating activities provided net cash of \$2.8 million and \$6.8 million, respectively. In the year ended December 31, 2012, our operating activities used net cash of \$15.3 million. A discussion of cash flow from operations for each of the last three years follows:

Year ended December 31, 2013. Cash provided by operations of \$2.8 million in 2013 was primarily the result of net income of \$2.6 million, which was increased for non-cash items related to depreciation and amortization of \$0.5 million and stock-based compensation expense of \$0.7 million. Cash provided from these sources was partially offset by \$1.0 million of net cash used to fund working capital items.

Year ended December 31, 2012. Cash used by operating activities of \$15.3 million in 2012 was primarily the result of: i) cash provided by on-going operations of \$6.7 million; less ii) income tax items on patent sales of \$22.0 million. A discussion of each of these factors follows:

Cash provided by on-going operations of \$6.7 million was the result of: i) operating income before patent related income of \$5.0 million; ii) interest income and other income of \$0.3 million; iii) adjustments for non-cash items related to depreciation and stock-based compensation of \$0.5 million and \$0.3 million, respectively; and iv) changes in working capital components that increased cash by \$0.6 million.

Cash provided by on-going operations of \$6.7 million was reduced by \$22.0 million of income tax items that were incurred as a result of our patent sales in 2012. The \$22.0 million of income tax items comprises: i) \$7.6 million of

tax payments; and ii) \$14.4 million of tax expense that is reduced by a tax benefit from excess stock-based compensation that must be presented as cash flows from financing activities under generally accepted accounting principles as opposed to an item that benefits cash flows from operating activities.

Year ended December 31, 2011. Cash provided by operations of \$6.8 million in 2011 was primarily the result of net income of \$2.6 million, which was increased for non-cash items related to depreciation and amortization of \$0.5 million and stock-based compensation expense of \$1.3 million. Cash provided by operations was also driven higher by a \$2.7 million reduction in accounts receivable and inventory, which was partially offset by a \$0.3 million reduction of liabilities.

#### Cash flow from investing activities

In the years ended December 31, 2013 and 2011, our investing activities used net cash of \$1.4 million and \$1.1 million, respectively. In the year ended December 31, 2012, our investing activities provided net cash of \$85.1 million. A discussion of cash flow from investing activities for each of the last three years follows:

Year ended December 31, 2013. Cash used by investing activities of \$1.4 million in 2013 was primarily the result of \$0.2 million of capital expenditures, \$0.9 million of net investment purchases, and \$0.3 million used to purchase other assets.

Year ended December 31, 2012. Cash provided by investing activities of \$85.1 million in 2012 was primarily due to \$86.4 million of net proceeds from the sale of patent assets. Cash provided from the sale of patent assets was reduced by: i) \$0.1 million of capital expenditures; and ii) \$1.2 million of net investment purchases.

Year ended December 31, 2011. Cash used by investing activities of \$1.1 million in 2011 was primarily the result of \$0.3 million of capital expenditures and \$0.7 million used to purchase investments.

We have no material commitments for capital expenditures.

#### Cash flow from financing activities

In the years ended December 31, 2013 and 2011, our financing activities provided net cash of \$122,000 and \$0.9 million, respectively. In the year ended December 31, 2012, our financing investing activities used net cash of \$45.3 million. A discussion of cash flow from financing activities for each of the last three years follows:

Year ended December 31, 2013. Cash provided by financing activities of \$122,000 in 2013 was primarily the result of \$65,000 of proceeds from the issuance of stock under employee stock programs and \$128,000 of excess tax benefits from stock-based compensation. Cash provided by these two factors was partially offset by \$71,000 used to repurchase stock from employees in connection with stock issuances under a 2013 stock grant.

Year ended December 31, 2012. Cash used by financing activities of \$45.3 million in 2012 was primarily the result of \$66.0 million of dividend payments and \$0.2 million used to repurchase stock from employees in connection with stock issuances under a 2010 stock grant program. Cash usage by these two factors was partially offset by: i) \$6.5 million of proceeds from the exercise of stock options; and ii) a \$14.4 million tax benefit related to excess stock-based compensation.

Year ended December 31, 2011. Cash provided by financing activities of \$0.9 million in 2011 was primarily the result of \$1.8 million of proceeds from the exercise of stock options. Proceeds from stock option exercises were partially offset by \$0.7 million used to repurchase our stock from a shareholder in a privately negotiated transaction, and \$0.2 million used to repurchase stock from employees in connection with stock issuances under a 2010 stock grant program.

At December 31, 2013, we had cash and cash equivalents of \$72.7 million and investments of \$2.8 million. While we cannot assure you that we will not require additional financing, or that such financing will be available to us, we believe that our cash and cash equivalents and investments will be sufficient to fund our operations for at least the next twelve months.

To date, inflation has not had a material impact on our financial results. There can be no assurance, however, that inflation will not adversely affect our financial results in the future.

#### OFF-BALANCE SHEET ARRANGEMENTS

We do not currently have any arrangements with unconsolidated entities, such as entities often referred to as structured finance, special purpose entities, or variable interest entities which are often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Accordingly, we are not exposed to any financing, liquidity, market or credit risk if we had such relationships.

During 2011 and 2012 we disclosed that we had a patent arrangement with an unaffiliated third party that we classified as a variable interest entity. We also disclosed that: i) we had no equity interest in this entity; ii) we were not contractually obligated to fund this entity, therefore our maximum exposure to loss as a result of our involvement with this entity was zero; iii) we may receive royalties in the future if certain conditions are met; iv) we were not the primary beneficiary of this entity; v) we have not consolidated this entity's results into our financial statements, therefore we carried the assets and liabilities of this entity in our balance sheet at zero; and vi) prior to September 30, 2012, this arrangement had no impact on our results of operations, financial position or cash flows in any previous periods.

In August 2012, certain contractual provisions of the arrangement were amended. As a result, the arrangement was no longer considered a variable interest entity under generally accepted accounting principles, and we ceased to classify it as such once the amendment was signed.

## CONTRACTUAL OBLIGATIONS

We have various contractual obligations impacting our liquidity. The following represents our contractual obligations as of December 31, 2013 (in thousands):

| Contractual Obligations | Total | Payments Due By Period |           |           |                      |
|-------------------------|-------|------------------------|-----------|-----------|----------------------|
|                         |       | Less than<br>1 year    | 1-3 years | 3-5 years | More than<br>5 years |
| Purchase orders         | \$ 57 | \$ 57                  | \$ -      | \$ -      | \$ -                 |
| Total                   | \$ 57 | \$ 57                  | \$ -      | \$ -      | \$ -                 |

## CRITICAL ACCOUNTING POLICIES

We consider certain accounting policies related to revenue recognition, stock-based compensation, income taxes, and the allowance for doubtful accounts to be critical policies.

**Revenue recognition.** We derive revenue from five sources: (i) software licenses; (ii) software maintenance; (iii) services; iv) hardware sales; and (v) royalties.

We recognize revenue when there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and delivery has occurred or services have been rendered. As described below, we make significant judgments during the process of determining revenue for any particular accounting period.

In determining revenue recognition, we assess whether fees associated with revenue transactions are fixed or determinable based on the terms of the contract and based on payment terms. If the fee is not fixed or determinable, we defer the fee and recognize revenue as amounts become due and payable. We assess whether collection is reasonably assured based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured.

We must also make judgments with respect to the recognition of revenue for multiple element revenue arrangements. We recognize revenue for multiple element arrangements as follows:

- o When software licenses and maintenance contracts are sold together, we recognize software license revenue upon delivery, provided we have vendor specific objective evidence (“VSOE”) for the fair value of the maintenance contract fee, and we recognize the fair value of maintenance contract revenue ratably over the related contract period.
- o When engineering services and software licenses are sold together, the total fee is generally recognized by applying contract accounting. We have adopted the percentage-of-completion method of contract accounting, and we primarily use an input method (i.e., labor hours) to determine our completion percentage.
- o When we sell services, software licenses and maintenance together, revenue is recognized as follows: i) maintenance revenue is separated from the other two elements and is recognized ratably over the related contract period; provided



we have VSOE for the fair value of the maintenance element; and ii) the total fee from the software license and engineering service elements is recognized by applying the contract accounting method described in the previous paragraph.

o We have a multiple element arrangement with one customer that involves the delivery of hardware, maintenance, and services. We determined that these elements qualified as separate units of accounting because they have value to the customer on a standalone basis. Accordingly, we recognize hardware revenue upon delivery and acceptance by the customer, maintenance revenue ratably over the related contract period, and service revenue as services are delivered.

Our revenue recognition policies are described more fully in Note 2, Summary of Significant Accounting Policies, in the Notes to our Consolidated Financial Statements.

**Stock-Based Compensation.** We grant stock options and stock to our employees and directors. We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense over the applicable vesting period of the award using the straight-line basis.

We use the Black-Scholes valuation model to estimate the fair value of stock option awards. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. The assumptions used to estimate the fair value of stock options 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.

For stock awards, we determine the fair value of the award by using the fair market value of our stock on the date of grant; provided the number of shares in the grant is fixed on the grant date.

**Income taxes.** As part of the process of preparing our consolidated financial statements we are required to estimate our actual current tax expense. We must also estimate temporary and permanent differences that result from differing treatment of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period for deferred tax assets, which have been recognized, we must include an expense with the tax provision in the statement of operations. Conversely, to the extent we decrease our valuation allowance in a period for deferred tax assets, which have been previously reserved, we must include a tax benefit with the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets, and any valuation allowance recorded against our net deferred tax assets. Our deferred tax assets primarily relate to temporary differences that result from differing treatment of certain items for tax and accounting purposes. As of December 31, 2013, we had a total of \$1.1 million of deferred tax assets for which we had recorded no valuation allowance.

We will continue to assess the level of valuation allowance required in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

**Allowance for doubtful accounts.** We make judgments as to our ability to collect outstanding receivables and provide allowances for receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. If the judgments we make to determine the allowance for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be required.

## RECENT ACCOUNTING PRONOUNCEMENTS

There were no recently issued accounting pronouncements applicable to us that we had not adopted as of December 31, 2013.

## ITEM 7A. 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 at December 31, 2013 consisted of two elements:

1. Cash and cash equivalents. As of December 31, 2013, our cash and cash equivalents of \$72.7 million were primarily invested in money market funds. The money market funds were invested in high quality, short term financial instruments. Due to the nature, short duration, and professional management of these funds, we do not expect that a general increase in interest rates would result in any material loss.
2. Investments. As of December 31, 2013, our investments of \$2.8 million were invested in high yield bonds with five corporate debt issuers, which mature in 2015 through 2018. While we are exposed to default risk, the high current yield of these bonds largely mitigates interest rate risk. Therefore, due to the high current yield and the two to five year life of these instruments, we do not believe that a general increase in interest rates would result in any material loss.

We do not use derivative financial instruments for speculative or trading purposes.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders of Aware, Inc.:

We have audited the accompanying consolidated balance sheets of Aware, Inc. (“the Company”) as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, stockholders’ equity, and cash flows for the years then ended, and the financial statement schedule listed in Item 15a as of December 31, 2013 and 2012. We also have audited Aware Inc.’s internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. The Company’s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Aware, Inc. as of December 31, 2013 and 2012, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America, and in our opinion, the related financial statement schedule for the years ended December 31, 2013 and 2012, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein. Also in our opinion, Aware, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ McGladrey LLP  
Boston, Massachusetts  
February 18, 2014

Report of Independent Registered Public Accounting Firm

To Board of Directors and Stockholders of Aware, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15 (a) (1) present fairly, in all material respects, the results of operations and cash flows of Aware, Inc. and its subsidiary for the year ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule for the year ended December 31, 2011 listed in the index appearing under Item 15 (a) (2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and on the financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP  
Boston, Massachusetts

February 21, 2012 except for the effects of discontinued operations discussed in Note 4 to the consolidated financial statements, as to which the date is February 18, 2014.

AWARE, INC.  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except share data)

|   | December 31, |           |
|---|--------------|-----------|
|   | 2013         | 2012      |
| <b>ASSETS</b>   |              |           |
| Current assets:   |              |           |
| Cash and cash equivalents   | \$72,660     | \$71,074  |
| Accounts receivable (less allowance for doubtful accounts of \$20 at December 31, 2013 and 2012)  | 4,582        | 3,457     |
| Receivable from patent arrangement  | -            | 1,121     |
| Inventories   | 1,601        | -         |
| Deferred tax assets   | 383          | 817       |
| Prepaid expenses and other current assets   | 695          | 528       |
| Total current assets  | 79,921       | 76,997    |
| Property and equipment, net   | 5,582        | 5,904     |
| Investments   | 2,754        | 2,010     |
| Long term deferred tax assets   | 762          | 943       |
| Other assets  | 310          | -         |
| Total assets  | \$89,329     | \$85,854  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |              |           |
| Current liabilities:  |              |           |
| Accounts payable  | \$1,516      | \$328     |
| Accrued expenses  | 108          | 148       |
| Accrued compensation  | 571          | 817       |
| Accrued professional fees   | 118          | 142       |
| Deferred revenue  | 1,848        | 2,204     |
| Total current liabilities   | 4,161        | 3,639     |
| Long-term deferred revenue  | 18           | 319       |
| Commitments and contingent liabilities (Note 9)   |              |           |
| Stockholders' equity:   |              |           |
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized, none outstanding  | -            | -         |
| Common stock, \$.01 par value; shares authorized, 70,000,000 in 2013 and 2012; issued and outstanding 22,574,251 in 2013 and 22,509,518 in 2012 | 226          | 225       |
| Additional paid-in capital  | 101,293      | 100,561   |
| Accumulated other comprehensive loss  | (125 )       | (50 )     |
| Accumulated deficit   | (16,244 )    | (18,840 ) |

|  |          |          |
|--|----------|----------|
| Total stockholders' equity                 | 85,150   | 81,896   |
| Total liabilities and stockholders' equity | \$89,329 | \$85,854 |

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



AWARE, INC.  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME  
(in thousands, except per share data)

|   | Years ended December 31, |           |          |
|---|--------------------------|-----------|----------|
|   | 2013                     | 2012      | 2011     |
| Revenue:  |                          |           |          |
| Software licenses                                       | \$ 8,241                 | \$ 9,525  | \$ 7,801 |
| Software maintenance                                    | 3,866                    | 3,038     | 2,590    |
| Services  | 3,148                    | 2,571     | 3,662    |
| Hardware sales  | 3,182                    | -         | -        |
| Royalties   | 920                      | 2,170     | 2,146    |
| Total revenue   | 19,357                   | 17,304    | 16,199   |
| Costs and expenses:                                     |                          |           |          |
| Cost of hardware sales                                  | 2,365                    | -         | -        |
| Cost of services  | 1,503                    | 1,542     | 1,518    |
| Research and development                                | 4,085                    | 3,489     | 3,203    |
| Selling and marketing                                   | 3,344                    | 3,370     | 2,973    |
| General and administrative                              | 3,522                    | 3,860     | 5,005    |
| Total costs and expenses                                | 14,819                   | 12,261    | 12,699   |
| Operating income before patent related income           | 4,538                    | 5,043     | 3,500    |
| Gain on sale of patent assets                           | -                        | 86,394    | -        |
| Income from patent arrangement                          | 780                      | 1,121     | -        |
| Operating income after patent related income            | 5,318                    | 92,558    | 3,500    |
| Other income  | 23                       | 85        | -        |
| Interest income   | 328                      | 227       | 83       |
| Income from continuing operations before income taxes   | 5,669                    | 92,870    | 3,583    |
| Provision for income taxes                              | 1,917                    | 20,487    | 2        |
| Income from continuing operations                       | 3,752                    | 72,383    | 3,581    |
| Loss from discontinued operations, net of income taxes  | (1,156 )                 | (76 )     | (1,014 ) |
| Net income  | \$ 2,596                 | \$ 72,307 | \$ 2,567 |
| Basic net income per share:                             |                          |           |          |
| Basic net income per share from continuing operations   | \$ 0.17                  | \$ 3.32   | \$ 0.17  |
| Basic net loss per share from discontinued operations   | (0.05 )                  | (0.00 )   | (0.05 )  |
| Basic net income per share                              | \$ 0.12                  | \$ 3.32   | \$ 0.12  |
| Diluted net income per share:                           |                          |           |          |
| Diluted net income per share from continuing operations | \$ 0.16                  | \$ 3.28   | \$ 0.17  |
| Diluted net loss per share from discontinued operations | (0.05 )                  | (0.00 )   | (0.05 )  |
| Diluted net income per share                            | \$ 0.11                  | \$ 3.28   | \$ 0.12  |
| Weighted-average shares - basic                         | 22,543                   | 21,814    | 20,534   |
| Weighted-average shares - diluted                       | 22,641                   | 22,071    | 20,735   |

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|  |          |           |          |
|--|----------|-----------|----------|
| Comprehensive income:                              |          |           |          |
| Net income   | \$ 2,596 | \$ 72,307 | \$ 2,567 |
| Other comprehensive income (net of tax):           |          |           |          |
| Unrealized losses on available for sale securities | (75 )    | (30 )     | (20 )    |
| Comprehensive income                               | \$ 2,521 | \$ 72,277 | \$ 2,547 |

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

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

|   | Years ended December 31, |           |          |
|---|--------------------------|-----------|----------|
|   | 2013                     | 2012      | 2011     |
| Cash flows from operating activities:   |                          |           |          |
| Net income  | \$2,596                  | \$72,307  | \$2,567  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                          |           |          |
| Depreciation and amortization   | 458                      | 453       | 475      |
| Stock-based compensation  | 662                      | 321       | 1,277    |
| Gain on sale of patent assets   | -                        | (86,394 ) | -        |
| Amortization of premium (discount) on investments   | 15                       | (18 )     | (9 )     |
| Gain on sale of investments   | (23 )                    | (85 )     | -        |
| Deferred tax benefit on other comprehensive income  | 81                       | -         | -        |
| Loss on disposal of property and equipment  | 28                       | -         | -        |
| Provision for doubtful accounts   | -                        | 4         | -        |
| Increase (decrease) from changes in assets and liabilities:                                 |                          |           |          |
| Accounts receivable   | (1,125 )                 | 85        | 1,422    |
| Receivable from patent arrangement  | 1,121                    | (1,121 )  | -        |
| Inventories   | (1,601 )                 | 547       | 1,316    |
| Prepaid expenses and other current assets   | (167 )                   | (315 )    | 22       |
| Deferred tax assets   | 563                      | (1,760 )  | -        |
| Accounts payable  | 1,188                    | (71 )     | (166 )   |
| Accrued expenses, compensation and professional   | (310 )                   | 9         | (590 )   |
| Deferred revenue  | (657 )                   | 744       | 515      |
| Net cash provided by (used in) operating activities   | 2,829                    | (15,294 ) | 6,829    |
| Cash flows from investing activities:   |                          |           |          |
| Purchases of property and equipment   | (160 )                   | (116 )    | (331 )   |
| Proceeds from sale of property and equipment  | 24                       | -         | -        |
| Purchases of investments  | (2,008 )                 | (2,065 )  | (737 )   |
| Sales of investments  | 1,117                    | 855       | -        |
| Proceeds from sale of patent assets, net  | -                        | 86,394    | -        |
| Purchase of other assets  | (338 )                   | -         | -        |
| Net cash provided by (used in) investing activities   | (1,365 )                 | 85,068    | (1,068 ) |
| Cash flows from financing activities:   |                          |           |          |
| Proceeds from issuance of common stock  | 65                       | 6,526     | 1,826    |

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|   |          |           |          |
|---|----------|-----------|----------|
| Payment of dividends  | -        | (66,024 ) | -        |
| Excess tax benefits from stock-based compensation   | 128      | 14,395    | -        |
| Payments made for taxes of employees who surrendered shares related to unrestricted stock | (71 )    | (174 )    | (224 )   |
| Repurchase of common stock  | -        | -         | (735 )   |
| Net cash provided by (used in) financing activities                                       | 122      | (45,277 ) | 867      |
| Increase in cash and cash equivalents   | 1,586    | 24,497    | 6,628    |
| Cash and cash equivalents, beginning of year  | 71,074   | 46,577    | 39,949   |
| Cash and cash equivalents, end of year  | \$72,660 | \$71,074  | \$46,577 |
| Supplemental disclosure:  |          |           |          |
| Cash paid for income taxes  | \$542    | \$7,954   | \$2      |

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

AWARE, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(in thousands)

|  | Common<br>Shares | Stock<br>Amount | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Loss | (Accumulated<br>Deficit) | Total<br>Stockholders'<br>Equity |
|--|------------------|-----------------|----------------------------------|---|--------------------------|----------------------------------|
| Balance at December 31,<br>2010  | 20,042           | \$200           | \$77,373                         | \$ -  | (\$ 27,690 )             | \$ 49,883                        |
| Exercise of common stock<br>options  | 596              | 6               | 1,804                            |   |                          | 1,810                            |
| Issuance of unrestricted stock   | 300              | 3               | (3 )                             |   |                          | -                                |
| Shares surrendered by<br>employees to pay taxes<br>related to unrestricted stock | (70 )            | (1 )            | (223 )                           |   |                          | (224 )                           |
| Repurchase of common stock   | (250 )           | (2 )            | (733 )                           |   |                          | (735 )                           |
| Issuance of common stock<br>under<br>employee stock purchase<br>plan             | 5                | -               | 17                               |   |                          | 17                               |
| Stock-based compensation<br>expense  | -                | -               | 1,277                            |   |                          | 1,277                            |
| Accumulated other<br>comprehensive loss:<br>Unrealized loss on securities        |                  |                 |                                  | (20 )   |                          | (20 )                            |
| Net income   |                  |                 |                                  |   | 2,567                    | 2,567                            |
| Balance at December 31,<br>2011  | 20,623           | 206             | 79,512                           | (20 )   | (25,123 )                | 54,575                           |
| Exercise of common stock<br>options  | 1,764            | 18              | 6,481                            |   |                          | 6,499                            |
| Issuance of unrestricted stock   | 151              | 1               | (1 )                             |   |                          | -                                |
| Shares surrendered by<br>employees to pay taxes<br>related to unrestricted stock | (33 )            | -               | (174 )                           |   |                          | (174 )                           |
| Issuance of common stock<br>under employee stock<br>purchase plan                | 5                | -               | 27                               |   |                          | 27                               |
| Stock-based compensation<br>expense  | -                | -               | 321                              |   |                          | 321                              |
| Tax benefits from<br>stock-based awards  |                  |                 | 14,395                           |   |                          | 14,395                           |
| Dividend payment   |                  |                 |                                  |   | (66,024 )                | (66,024 )                        |

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|  |        |       |           |         |   |              |           |
|--|--------|-------|-----------|---------|---|--------------|-----------|
| Accumulated other comprehensive loss:                                      |        |       |           |         |   |              |           |
| Unrealized loss on securities  |        |       |           | (30     | ) |              | (30 )     |
| Net income   |        |       |           |         |   | 72,307       | 72,307    |
| Balance at December 31, 2012   | 22,510 | 225   | 100,561   | (50     | ) | (18,840 )    | 81,896    |
| Exercise of common stock options   | 6      | -     | 26        |         |   |              | 26        |
| Issuance of unrestricted stock   | 65     | 1     | (1        | )       |   |              | -         |
| Shares surrendered by employees to pay taxes related to unrestricted stock | (14    | )     | -         | (71     | ) |              | (71 )     |
| Issuance of common stock under employee stock purchase plan                | 7      | -     | 40        |         |   |              | 40        |
| Stock-based compensation expense   | -      | -     | 662       |         |   |              | 662       |
| Tax benefits from stock-based awards                                       |        |       | 128       |         |   |              | 128       |
| Deferred tax asset write-off   |        |       | (52       | )       |   |              | (52 )     |
| Accumulated other comprehensive loss:                                      |        |       |           |         |   |              |           |
| Unrealized loss on securities  |        |       |           | (156    | ) |              | (156 )    |
| Deferred tax benefit on unrealized losses                                  |        |       |           | 81      |   |              | 81        |
| Net income   |        |       |           |         |   | 2,596        | 2,596     |
| Balance at December 31, 2013   | 22,574 | \$226 | \$101,293 | (\$ 125 | ) | (\$ 16,244 ) | \$ 85,150 |

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

AWARE, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF BUSINESS

We are a leading provider of software and services to the biometrics industry. Our software products are used in government and commercial biometrics systems, which are capable of determining or verifying an individual's identity. We also offer engineering services related to software customization, integration, and installation, as well as complete systems development. We sell our biometrics software products and services globally through systems integrators, OEMs, and directly to end user customers

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** - The consolidated financial statements include the accounts of Aware, Inc. and its subsidiary. All significant intercompany transactions have been eliminated.

**Use of Estimates** – The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. The most significant estimates included in the financial statements pertain to revenue recognition, reserves for doubtful accounts, useful lives of fixed assets, valuation allowance for deferred income tax assets, and accrued liabilities. Actual results could differ from those estimates.

**Fair Value Measurements** - The Financial Accounting Standards Board (“FASB”) Codification defines fair value, and establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to the unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under the FASB Codification are: i) Level 1 – valuations that are based on quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date; ii) Level 2 – valuations that are based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly; and iii) Level 3 – valuations that require inputs that are both significant to the fair value measurement and unobservable.

Cash and cash equivalents, which primarily include money market mutual funds, were \$72.7 million and \$71.1 million as of December 31, 2013 and December 31, 2012, respectively. We classified our cash equivalents of \$68.6 million and \$67.1 million as of December 31, 2013 and 2012, respectively, within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

Our investments, which consist of high yield corporate debt securities, are also classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices. We categorize our investments as available-for-sale securities, and carry them at fair value in our financial statements. We had \$2.8 million and \$2.0 million of available-for-sale investments as of December 31, 2013 and December 31, 2012, respectively.

As of December 31, 2013, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

Fair Value Measurement at December 31, 2013 Using:  
Quoted Prices

|  | in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|---|---|--|
| Corporate debt securities                                  | \$ 2,754  | \$ -  | \$ -   |
| Money market funds (included in cash and cash equivalents) | 68,556  |   |  |
| Total  | \$ 71,310   | \$ -  | \$ -   |



AWARE, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2012, our assets that are measured at fair value on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

|  | Fair Value Measurement at December 31, 2012 Using:                               |   |  |
|--|--|---|--|
|  | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Corporate debt securities                                  | \$ 2,010   | \$ -  | \$ -   |
| Money market funds (included in cash and cash equivalents) | 67,050   |   |  |
| Total  | \$ 69,060  | \$ -  | \$ -   |

Cash and Cash Equivalents – Cash and cash equivalents, which consist primarily of money market funds and demand deposits, are stated at fair value. All highly liquid investments purchased with an original maturity of three months or less are considered cash equivalents. Our cash balances exceed the Federal Deposit Insurance Corporation limits. The Company does not believe it is exposed to significant credit risk related to cash and cash equivalents.

Investments - At December 31, 2013 and 2012, we categorized all investment securities as available-for-sale, since we may liquidate these investments currently. In calculating realized gains and losses, cost is determined using specific identification. Unrealized gains and losses on available-for-sale securities are excluded from earnings and reported in a separate component of stockholders' equity called Accumulated Comprehensive Income.

Realized gains on investments were \$23,000 and \$85,000 in the years ended December 31, 2013 and 2012, respectively. There were no realized gains or losses on investments in the year ended December 31, 2011.

Unrealized losses on investments were \$156,000, \$30,000, and \$20,000 in the years ended December 31, 2013, 2012, and 2011.

The amortized cost of our corporate debt securities was \$3.0 million at December 31, 2013. Corporate debt securities comprising investments mature in 2015 to 2018.

Allowance for Doubtful Accounts – Accounts are charged to the allowance for doubtful accounts as they are deemed uncollectible based on a periodic review of the accounts.

Inventories – Inventories are stated at the lower of cost or net realizable value. Cost is determined by the first-in, first-out (“FIFO”) method. We evaluate all inventories for net realizable value on a quarterly basis, and record provisions for excess and obsolete inventory when required. There was no reserve for excess and obsolete inventory as of December 31, 2013.

Property and Equipment – Property and equipment is stated at cost. Depreciation and amortization of property and equipment is provided using the straight-line method over the estimated useful lives of the assets. Upon retirement or sale, the costs of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss on disposal is included in the determination of income or loss. Expenditures for repairs and maintenance are charged to expense as incurred.

The estimated useful lives of assets used by us are:

|  |               |
|--|---------------|
| Building                                   | 30 years      |
| Building improvements                      | 5 to 20 years |
| Furniture and fixtures                     | 5 years       |
| Computer, office & manufacturing equipment | 3 years       |
| Purchased software                         | 3 years       |

AWARE, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Impairment of Long-Lived Assets** – We review long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows estimated to be generated by those assets over their estimated economic life to the related carrying value of those assets to determine if the assets are impaired. If an impairment is indicated, the asset is written down to its estimated fair value. The cash flow estimates used to identify the potential impairment reflect our best estimates using appropriate assumptions and projections at that time. We believe that no significant impairment of our long-lived assets has occurred as of December 31, 2013 and 2012.

**Revenue Recognition** – We recognize revenue when there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and delivery has occurred or services have been rendered.

**Persuasive evidence of an arrangement:** We use contracts signed by both the customer and us or written purchase orders issued by the customer as evidence of an arrangement.

**Product delivery:** We deem delivery to have occurred: (i) upon shipment when products are shipped FOB shipping point, or (ii) upon delivery at a customer's location when products are shipped FOB destination, or (iii) when software is delivered electronically. If customer acceptance provisions apply, revenue is not recognized until delivery has occurred and we have received such acceptance. If we are required to provide installation services, revenue is not recognized until installation is complete.

**Fixed or determinable fee:** We consider fees to be fixed or determinable if the fee is not subject to refund or adjustment and the payment terms are within normal established practices. If the fee is not fixed or determinable, we recognize the revenue as amounts become due and payable.

**Collection is deemed probable:** We conduct a credit review for significant transactions at the time of the arrangement to determine the credit-worthiness of the customer. Collection is deemed probable if we expect that the customer will pay amounts under the arrangement as payments become due.

We categorize revenue as software licenses, software maintenance, services, hardware sales, or royalties. In addition to the general revenue recognition policies described above, specific revenue recognition policies apply to each category of revenue.

**Software licenses**

Software licenses consist of revenue from the sale of software licenses for biometrics and imaging applications. We recognize revenue from software licenses upon delivery when licenses are sold in single element arrangements.

**Software maintenance**

Software maintenance consists of revenue from the sale of software maintenance contracts for biometrics and imaging software. Software maintenance contracts entitle customers to receive software support and software updates, if and when they become available, during the term of the maintenance contract. We recognize software maintenance revenue ratably over the related contract period.

#### Services

Service revenue consists of fees from biometrics customers for engineering services we provide to them. We recognize services revenue as services are delivered when services are sold in single element arrangements.

#### Hardware sales

Hardware sales consist of sales of biometrics equipment to a single U.S. government customer. We recognize hardware sales upon delivery and acceptance of the equipment by the customer.

#### Royalties

Royalty revenue consists of royalties we receive under DSL silicon IP contracts with customers that have incorporated our intellectual property into their products. Since we cannot reasonably estimate royalty revenue, such revenue is recognized in the quarter in which a final report is received from a customer. Royalty reports are typically received in the quarter immediately following the quarter in which sales of royalty-bearing products occur.

AWARE, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Multiple element arrangements

In addition to selling software licenses, software maintenance and services in single element arrangements, we also sell these three products and hardware as part of multiple element arrangements. The various combinations of multiple element arrangements and our revenue recognition for each are described as follows:

Software licenses and software maintenance. When software licenses and software maintenance contracts are sold together, we recognize software license revenue upon delivery, provided we have vendor specific objective evidence (“VSOE”) for the fair value of the maintenance contract fee, and we recognize the fair value of maintenance contract revenue ratably over the related contract period.

Software licenses and services. When software licenses and engineering services are sold together, the total fee is generally recognized by applying contract accounting. We have adopted the percentage-of-completion method of contract accounting, and we generally use an input method (i.e., labor hours) to determine our completion percentage. The software license portion of the arrangement is classified as software license revenue and the engineering services portion is classified as services revenue.

Software licenses, software maintenance and services. When we sell software licenses, software maintenance and services together, revenue is recognized as follows: i) software maintenance revenue is separated from the other two elements and is recognized ratably over the related software maintenance contract period; provided we have VSOE for the fair value of the maintenance element; and ii) the total fee from the software license and engineering service elements is recognized by applying the contract accounting method described in the previous paragraph.

Hardware sales, software maintenance, and services. We have a multiple element arrangement with one customer that involves the delivery of hardware, maintenance, and services. We determined that these elements qualified as separate units of accounting because they have value to the customer on a standalone basis. We recognize revenue from this arrangement as follows: i) hardware revenue is recognized upon delivery and acceptance of the equipment by the customer; ii) maintenance revenue is recognized ratably over the related contract period; and iii) service revenue is recognized as services are delivered.

Income Taxes – We compute deferred income taxes based on the differences between the financial statement and tax basis of assets and liabilities using enacted rates in effect in the years in which the differences are expected to reverse. We establish a valuation allowance to offset temporary deductible differences, net operating loss carryforwards and tax credits when it is more likely than not that the deferred tax assets will not be realized.

We recognize the tax benefit from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained upon examination by the taxing authorities, based on the technical merits of the tax position. The evaluation of an uncertain tax position is based on factors that include, but are not limited to, changes in the tax law, the measurement of tax positions taken or expected to be taken in tax returns, the effective settlement of matters subject to audit, and changes in facts or circumstances related to a tax position. Any changes to these estimates, based on the actual results obtained and/or a change in assumptions, could impact our tax provision in future periods. Interest and penalty charges, if any, related to unrecognized tax benefits would be classified as a provision for income tax in the statement of income.

Capitalization of Software Costs – We capitalize certain internally developed software development costs after technological feasibility of the product has been established. No software costs were capitalized for the years ended December 31, 2013, 2012 and 2011, because such costs incurred subsequent to the establishment of technological feasibility, but prior to commercial availability, were immaterial.

Research and Development Costs – Costs incurred in the research and development of our products are expensed as incurred.

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Concentration of Credit Risk – At December 31, 2013 and 2012, we had cash and cash equivalents, in excess of federally insured deposit limits of approximately \$72.4 million and \$70.8 million, respectively.

Concentration of credit risk with respect to net accounts receivable consisted of \$2.7 million, \$0.2 million, \$0.2 million, \$0.2 million and \$0.2 million with five customers, respectively, at December 31, 2013, and \$1.1 million, \$0.6 million, \$0.5 million, \$0.4 million and \$0.3 million with five customers, respectively, at December 31, 2012.

Concentration of credit risk with respect to our investment portfolio consisted of \$0.8 million, \$0.5 million, \$0.5 million, \$0.5 million, and \$0.4 million with five issuers of corporate debt securities, respectively, at December 31, 2013, and \$1.0 million and \$1.0 million with two issuers of corporate debt securities, respectively, at December 31, 2012.

Stock-Based Compensation – We grant stock options and stock to our employees and directors. We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize stock-based compensation expense on a straight-line basis over the requisite service period of the award.

We use the Black-Scholes option valuation model to estimate the fair value of stock option awards. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. The assumptions used to estimate the fair value of stock options 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.

For stock awards, we determine the fair value of the award by using the fair market value of our stock on the date of grant; provided the number of shares in the grant is fixed on the grant date.

Computation of Earnings per Share – Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing income available to common shareholders 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 antidilutive are excluded from the calculation.

Fair Value of Financial Instruments – The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value because of their short-term nature. The carrying amount of investments is based on the fair value of the individual securities in our investment portfolio.

Advertising Costs – Advertising costs are expensed as incurred and were not material for 2013, 2012, and 2011.

Recent Accounting Pronouncements – There were no recently issued accounting pronouncements applicable to us that we had not adopted as of December 31, 2013.

Reclassifications - Certain prior period amounts have been reclassified to be consistent with the current period presentation, particularly as a result of the discontinued operations presentation of our DSL service assurance business. See Note 4 to the Consolidated Financial Statements.

Segments – Following the shutdown of our DSL Service Assurance Segment as described in Note 4, we organize ourselves into a single segment reporting to the chief operating decision makers. We have sales outside of the United States, which are described in Note 10. All long-lived assets are maintained in the United States.

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3. PATENT RELATED INCOME

In the years ended December 31, 2013 and 2012, we derived patent related income from two sources, which are described below:

Gain on sale of patent assets. In 2011, we engaged an intellectual property law firm to help us conduct a process to sell a portion of our patent portfolio pertaining to wireless and certain DSL patents. The process produced two significant patent sales for a total of \$86.4 million of net gains in the year ended December 31, 2012. This income was included on a separate line of the consolidated statements of income and comprehensive income entitled "Gain on sale of patent assets." The two patent sales are described below:

Wireless patent sale. On April 26, 2012, we entered into an agreement with an unaffiliated third party to sell a portion of our patent portfolio pertaining to wireless technology for \$75.0 million. The proceeds from the sale were reduced by \$3.8 million of transaction costs, which consisted primarily of fees from the law firm that assisted us in the sale. The transaction closed in June 2012 and resulted in a gain of \$71.2 million.

DSL patent sale. On August 22, 2012, we entered into an agreement with an unaffiliated third party to sell a portion of our patent portfolio pertaining to digital subscriber line ("DSL") technology for \$16.0 million. The proceeds from the sale were reduced by \$0.8 million of transaction costs, which also consisted primarily of fees from the law firm that assisted us in the sale. The transaction closed in September 2012 and resulted in a gain of \$15.2 million.

Income from patent arrangement. In December 2010, we entered into an arrangement with an unaffiliated third party under which we assigned patents in return for royalties on proceeds from patent monetization efforts by the third party. In the years ended December 31, 2013 and 2012, we recorded income related to this arrangement of \$0.8 million and \$1.1 million, respectively. Such income was included on a separate line of the consolidated statements of income and comprehensive income entitled "Income from patent arrangement."

4. DISCONTINUED OPERATIONS

Our board of directors approved the shutdown of our DSL service assurance hardware and software product lines in 2012 and 2013, respectively. Both product lines were previously components of our DSL Service Assurance Segment. Results from the DSL Service Assurance Segment have been reported as discontinued operations because we no longer have any significant continuing involvement with, or cash flows from, this segment.

Loss from the discontinued DSL Service Assurance Segment was (in thousands):

|                                   | Years ended December 31, |          |             |
|-----------------------------------|--------------------------|----------|-------------|
|                                   | 2013                     | 2012     | 2011        |
| Revenue                           | \$ 3,216                 | \$ 5,431 | \$ 8,387    |
| Expenses                          | 5,120                    | 5,558    | 9,401       |
| Loss before income taxes          | (1,904 )                 | (127 )   | (1,014 )    |
| Income tax benefit                | (748 )                   | (51 )    | -           |
| Loss from discontinued operations | (\$ 1,156 )              | (\$ 76 ) | (\$ 1,014 ) |

The consolidated statements of income and comprehensive income for the years ended December 31, 2012 and 2011 have been reclassified to reflect the effect of discontinued operations as set forth above.

We incurred one-time costs related to the shutdown of the DSL service assurance hardware and software product lines. Shutdown costs for each product line were:

DSL service assurance hardware product line. In 2012, we incurred one-time shutdown costs related to the hardware product line of approximately \$282,000, the majority of which were severance and employee-related costs. All such costs were incurred, paid, and included in loss from discontinued operations for the year ended December 31, 2012.

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DSL service assurance software product line. In 2013, we incurred one-time shutdown costs related to the software product line of approximately \$2.9 million. Such costs comprise: i) \$3.7 million of payments to customers to terminate contracts, which were offset by \$1.2 million of deferred revenue obligations that were relieved as a result of such contract terminations; ii) \$311,000 of severance and employee-related costs; and iii) \$48,000 of asset write-offs. All such costs were incurred and included in loss from discontinued operations for the year ended December 31, 2013. All DSL service assurance software product line exit costs were paid in 2013, with the exception of \$90,000 of severance costs, which were paid in early January 2014.

The following table is a rollforward of our exit costs liability accounts. Unpaid severance and employee-related costs at December 31, 2013 were included in "Accrued compensation" in the consolidated balance sheets. (in thousands):

|                              | Customer<br>Contract<br>Termination<br>Costs | Severance<br>and<br>Employee-<br>Related Costs | Other<br>Costs | Total   |
|------------------------------|--|--|----------------|---------|
| Year ended December 31, 2013 |  |  |                |         |
| Balance at January 1, 2013   | \$ -   | \$ -   | \$ -           | \$ -    |
| Amount charged to expense    | 2,553  | 311  | 48             | 2,912   |
| Deferred revenue offset      | 1,179  | -  | -              | 1,179   |
| Payments/write-offs          | (3,732)                                      | (221)  | (48)           | (4,001) |
| Balance at December 31, 2013 | \$ -   | \$ 90  | \$ -           | \$ 90   |
| Year ended December 31, 2012 |  |  |                |         |
| Balance at January 1, 2012   | \$ -   | \$ -   | \$ -           | \$ -    |
| Amount charged to expense    | -  | 282  | -              | 282     |
| Payments                     | -  | (282)  | -              | (282)   |
| Balance at December 31, 2012 | \$ -   | \$ -   | \$ -           | \$ -    |

There were no assets or liabilities remaining on the balance sheet as of December 31, 2013 related to the DSL Service Assurance Segment, except for \$90,000 of severance costs, which were paid in early January 2014.

5. INVENTORIES

Inventories consisted of the following at December 31 (in thousands):

|                | 2013     | 2012 |
|----------------|----------|------|
| Raw materials  | \$ 1,584 | \$ - |
| Finished goods | 17       | -    |
| Total          | \$ 1,601 | \$ - |

6. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31 (in thousands):

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|  | 2013     | 2012     |
|--|----------|----------|
| Land   | \$ 1,056 | \$ 1,080 |
| Building and improvements                      | 9,060    | 9,060    |
| Computer equipment                             | 557      | 605      |
| Purchased software                             | 88       | 131      |
| Furniture and fixtures                         | 778      | 779      |
| Office equipment                               | 191      | 181      |
| Total  | 11,730   | 11,836   |
| Less accumulated depreciation and amortization | (6,148 ) | (5,932 ) |
| Property and equipment, net                    | \$ 5,582 | \$ 5,904 |

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Depreciation expense was \$0.5 million, \$0.4 million, and \$0.5 million, for the years ended December 31, 2013, 2012, and 2011, respectively. In 2013, 2012 and 2011, we identified \$266,000, \$958,000, and \$78,000, of assets no longer in use, and retired the assets and related accumulated depreciation.

## 7. INCOME TAXES

We made provisions for income taxes related to continuing operations in the years ended December 31, 2013 and 2012 of \$1.9 million and \$20.5 million, respectively. We made no provision for income taxes in the year ended 2011, except for \$2,000 of state excise taxes. The components of the provision for income taxes are as follows (in thousands):

|                                  | Year ended December 31, |           |      |
|----------------------------------|-------------------------|-----------|------|
|                                  | 2013                    | 2012      | 2011 |
| Current:                         |                         |           |      |
| Federal                          | \$ 1,000                | \$ 20,654 | \$ - |
| State                            | 273                     | 1,594     | 2    |
|                                  | 1,273                   | 22,248    | 2    |
| Deferred:                        |                         |           |      |
| Federal                          | 471                     | (1,354 )  | -    |
| State                            | 173                     | (407 )    | -    |
|                                  | 644                     | (1,761 )  | -    |
| Total provision for income taxes | \$ 1,917                | \$ 20,487 | \$ 2 |

A reconciliation of the U.S. federal statutory rate to the effective tax rate is as follows:

|  | Year ended December 31, |   |      |   |      |   |
|--|-------------------------|---|------|---|------|---|
|  | 2013                    |   | 2012 |   | 2011 |   |
| Federal statutory rate                             | 34                      | % | 35   | % | 34   | % |
| State rate, net of federal benefit                 | 5                       |   | 5    |   | 6    |   |
| Tax credits  | (2                      | ) | -    |   | (9   | ) |
| Permanent adjustments                              | (1                      | ) | -    |   | -    |   |
| Change in valuation allowance                      | -                       |   | (18  | ) | (50  | ) |
| Non-qualified option cancellations and forfeitures | -                       |   | -    |   | 11   |   |
| Nondeductible compensation expense                 | -                       |   | -    |   | (1   | ) |
| Prior year adjustment                              | (2                      | ) | -    |   | (2   | ) |
| Expiring NOLs and tax credits                      | -                       |   | -    |   | 10   |   |
| Other  | -                       |   | -    |   | 1    |   |
| Effective tax rate                                 | 34                      | % | 22   | % | 0    | % |

Total income tax expense for the year ended December 31, 2013 was \$1.2 million, including \$1.9 million that was recorded in continuing operations less a tax benefit of \$0.7 million that was recorded in discontinued operations. Income tax expense for 2013 was based on the U.S. statutory rate of 34%, increased by state income taxes. Tax expense in 2013 also reflects two items related to 2012, including:

a tax benefit of \$95,000 related to the 2012 research tax credit. This credit was extended retroactively back to January 1, 2012, by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013; and

a tax benefit of \$148,000 related to a reduction in the estimate of the 2012 tax expense recorded in our 2012 financial statements.

Total income tax expense for the year ended December 31, 2012 was \$20.4 million, including \$20.5 million that was recorded in continuing operations less a tax benefit of \$51,000 that was recorded in discontinued operations. The Company's actual tax liability for 2012 was \$7.8 million as taxes that were currently payable were reduced by a \$14.4 million equity adjustment. This equity adjustment is described more fully below.

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In 2012, we used a significant portion of our available deferred tax assets to reduce income taxes on pre-tax income. A substantial portion of the deferred tax assets we utilized comprised cumulative deductions for stock options in excess of book expense. Under income tax accounting rules, the portion of tax benefits attributable to such deductions must be recorded as an adjustment to equity versus a reduction of income tax expense. In the year ended December 31, 2012, the tax benefits from such stock-based awards were \$14.4 million, which we recorded as an equity adjustment to additional paid-in capital.

Income tax expense in 2012 was also reduced by a \$1.8 million reversal of the valuation allowance on our remaining deferred tax assets at December 31, 2012. We reversed the valuation allowance because based on all the available evidence, we believed that it is more likely than not that our deferred tax assets will be realizable. In reaching this determination, we evaluated: i) our most recent years operating results; ii) our future financial plans; and iii) the nature of the components comprising deferred tax assets at December 31, 2012.

As of December 31, 2013 and 2012, we had deferred tax assets for which we had recorded no valuation allowance. The principal components of deferred tax assets were as follows at December 31 (in thousands):

|   | 2013     | 2012     |
|---|----------|----------|
| Capitalized research and development costs                  | \$ 364   | \$ 817   |
| Research and development and other tax credit carryforwards | -        | 27       |
| Other   | 781      | 916      |
| Total   | 1,145    | 1,760    |
| Less valuation allowance                                    | (- )     | (- )     |
| Deferred tax assets, net                                    | \$ 1,145 | \$ 1,760 |

We will continue to assess the level of valuation allowance required in future periods. Should evidence regarding the realizability of tax assets change at a future point in time, the valuation allowance will be adjusted accordingly.

As a result of significant taxable income in 2012 and the utilization of research and development credits thereon, we conducted a review to determine whether any of our prior year research and development tax credits represented an uncertain tax position. Based on that review, we determined that \$1.9 million of federal credits and \$1.0 million of state credits could not be supported and therefore, those credits were written off. In addition to the write-off, we also determined that \$1.9 million of federal credits and \$1.0 million of state credits represented an uncertain tax position for which we established a valuation allowance. A rollforward of the uncertain tax position related to our research and development tax credits is as follows (in thousands):

|   |          |
|---|----------|
| Uncertain tax positions at<br>December 31, 2011     | \$ -     |
| Increase due to positions taken<br>in prior periods | 2,945    |
| Uncertain tax positions at<br>December 31, 2012     | \$ 2,945 |
| Increase due to positions taken<br>in prior periods | -        |
|   | \$ 2,945 |

Uncertain tax positions at  
December 31, 2013

Uncertain tax positions of \$2.6 million will impact our tax rate if realized. The difference between this amount and the total uncertain tax positions in the table above is the federal tax effect on state tax credits.

In addition to deferred tax assets carried on our balance sheet, we also had net federal and state research and development credit carryforwards available at December 31, 2013 of \$4.9 million and \$0.7 million. These credits were not recorded as tax assets as they relate to excess stock compensation deductions that may not be recorded as tax assets under generally accepted accounting principles until the amounts have been utilized to reduce our tax liability. To the extent that these assets are used to reduce future taxes, the benefit will be recorded as a reduction to additional paid-in capital. In 2013, we recorded a tax benefit of \$128,000 to equity related to the use of these tax credits to reduce our tax liability.

Our policy is to recognize interest and penalties related to uncertain tax positions in income tax expense. As of December 31, 2013, we had no accrued interest or penalties related to uncertain tax positions.



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The tax years from 1998 through 2013 are subject to examination by the IRS and state tax authorities.

## 8. EQUITY AND STOCK COMPENSATION PLANS

**Fixed Stock Option Plans** – We have two fixed option plans. Under our 1996 Stock Option Plan (“1996 Plan”), we were authorized to grant incentive stock options and nonqualified stock options to our employees and directors for up to 6,100,000 shares of common stock. There were no shares available for grant under the 1996 Plan as of December 31, 2013. Under our 2001 Nonqualified Stock Plan (“2001 Plan”), we are authorized to grant nonqualified stock options, stock appreciation rights and stock awards to our employees and directors for up to 8,000,000 shares of common stock. As of December 31, 2013, there were 4,632,086 shares available for grant under the 2001 Plan.

Under both plans, options are granted at exercise prices as determined by the Board of Directors and have terms ranging from four to a maximum of ten years. Our options generally vest over three to five years, although we have granted options in the past that were 50% or fully vested on the date of grant.

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

|                                   | Years ended December 31, |        |          |
|-----------------------------------|--------------------------|--------|----------|
|                                   | 2013                     | 2012   | 2011     |
| Cost of services                  | \$ 34                    | \$ 16  | \$ 29    |
| Research and development          | 81                       | 51     | 110      |
| Selling and marketing             | 14                       | 126    | 108      |
| General and administrative        | 533                      | 83     | 859      |
| Loss from discontinued operations | -                        | 45     | 171      |
| Stock-based compensation expense  | \$ 662                   | \$ 321 | \$ 1,277 |

Stock-based compensation expenses in the preceding table include expenses associated with grants of: i) stock options; ii) stock appreciation rights (SARs); and iii) unrestricted shares of our common stock. The method used to determine stock-based compensation expense for each type of equity grant is described in the following paragraphs.

**Stock Option and SAR Grants.** For the years ended December 31, 2013, 2012, and 2011, we granted stock options for 0, 50,000, and 0 shares, respectively. No SARs were granted during the three year period ended December 31, 2013. We estimate the fair value of stock options and SARs using the Black-Scholes valuation model.

The Black-Scholes valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. The assumptions used to estimate the fair value of stock options and SARs include the expected term, the expected volatility of our stock over the expected term, the risk-free interest rate over the expected term, and our expected annual dividend yield. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of stock options granted in the year ended December 31, 2012. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

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Specific assumptions used to determine the fair value of options granted during the years ended December 31, 2013, 2012 and 2011, using the Black-Scholes valuation model were:

|                                | Year Ended<br>December 31,<br>2013 | Year Ended<br>December 31,<br>2012 | Year Ended<br>December 31,<br>2011 |
|--------------------------------|------------------------------------|------------------------------------|------------------------------------|
| Expected term (1)              | n/a                                | 5 years                            | n/a                                |
| Expected volatility factor (2) | n/a                                | 58-63%                             | n/a                                |
| Risk-free interest rate (3)    | n/a                                | 0.92%                              | n/a                                |
| Expected annual dividend yield | n/a                                | n/a                                | n/a                                |

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(1) The expected term for each grant for the year ended December 31, 2012 was determined based on the contractual term of the option.

(2) The expected volatility for each grant is estimated based on an average of historical volatility over a period of time which we believe to be representative of our future volatility.

(3) The risk-free interest rate for each grant is based on the U.S. Treasury yield curve in effect at the time of grant for a period equal to the expected term of the stock option.

We do not estimate our forfeiture rates as the actual forfeiture rate is known at the end of each reporting period due to the timing of our stock option vesting.

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

We granted 130,000, 0, and 105,000 shares of unrestricted stock during the years ended December 31, 2013, 2012, and 2011, respectively. The accounting treatment of those awards is described below:

Year ended December 31, 2013. In April 2013, we granted 130,000 shares of unrestricted stock to directors, officers and employees. The shares were issued in two equal installments shortly after June 30, 2013 and December 31, 2013. We expensed \$623,000 of stock-based compensation expense related to this grant in the year ended December 31, 2013. There was no unamortized stock-based compensation charge associated with this stock grant as of December 31, 2013.

We issued shares of common stock related to the April 2013 grant as follows: i) 51,374 net shares of common stock were issued in early July 2013 after employees surrendered 13,626 shares for which we paid \$71,000 of withholding taxes on their behalf; and ii) 49,936 net shares of common stock were issued in early January 2014 after employees surrendered 15,064 shares for which we paid \$92,000 of withholding taxes on their behalf.

Year ended December 31, 2012. No shares of unrestricted stock were granted in 2012, however we granted shares of unrestricted common stock in 2010 that affected results for the year ended December 31, 2012. Activity in 2012 related to the 2010 stock grant was: i) 2012 stock-based compensation expense included \$189,000 related to the 2010 grant; and ii) we issued 118,113 net shares of common stock after employees surrendered 33,441 shares for which we paid \$174,000 of withholding taxes on their behalf.

Year ended December 31, 2011. Our former President and CEO resigned in April 2011. As part of his separation arrangement he was granted 105,000 shares of common stock, which resulted in a stock-based compensation charge of \$362,000 in the year ended December 31, 2011. We issued 71,662 net shares of common stock after he surrendered 33,338 shares for which we paid \$115,000 of withholding taxes on his behalf.

The aforementioned 2010 stock grant also affected results for the year ended December 31, 2011. Activity in 2011 related to the 2010 stock grant was: i) 2011 stock-based compensation expense included \$443,000 related to the 2010 grant; and ii) we issued a net of 157,988 shares of common stock after employees surrendered 36,998 shares for which

we paid \$109,000 of withholding taxes on their behalf.

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A summary of stock option transactions for our two fixed stock option plans for the years ended December 31, 2013, 2012, and 2011 are presented below:

|                                  | 2013      |                                 | 2012        |                                 | 2011        |                                 |
|----------------------------------|-----------|---------------------------------|-------------|---------------------------------|-------------|---------------------------------|
|                                  | Shares    | Weighted Average Exercise Price | Shares      | Weighted Average Exercise Price | Shares      | Weighted Average Exercise Price |
| Outstanding at beginning of year | 1,063,025 | \$5.63                          | 2,835,952   | \$4.42                          | 5,082,891   | \$4.30                          |
| Granted                          | -         | -                               | 50,000      | 4.60                            | -           | -                               |
| Exercised                        | (6,163 )  | 4.27                            | (1,779,616) | 3.71                            | (632,685 )  | 3.02                            |
| Forfeited or cancelled           | (51,873 ) | 4.83                            | (43,311 )   | 4.33                            | (1,614,254) | 4.59                            |
| Outstanding at end of year       | 1,004,989 | \$5.68                          | 1,063,025   | \$5.63                          | 2,835,952   | \$4.42                          |
| Exercisable at year end          | 986,237   | \$5.70                          | 1,027,525   | \$5.66                          | 2,772,109   | \$4.44                          |

The number of option shares vested and expected to vest at December 31, 2013 was 1,004,989 and those options had a weighted average exercise price of \$5.68.

No stock options were granted in the years ended December 31, 2013 and 2011. All options granted during the year ended December 31, 2012 had exercise prices equal to the fair market value of our common stock on the date of grant, and the weighted average grant date fair values of options granted were \$2.38.

At December 31, 2013, the weighted average remaining contractual term for total options outstanding and total options exercisable was approximately 1 year for each.

At December 31, 2013, the aggregate intrinsic value of options outstanding and options exercisable was approximately \$0.4 million for each. The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. The aggregate intrinsic value of options exercised during the year ended December 31, 2013 was approximately \$4,000.

The following table summarizes the stock options outstanding at December 31, 2013:

| Exercise Price Range | Number | Options Outstanding             |  | Options Exercisable |                                 |
|----------------------|--------|---------------------------------|--|---------------------|---------------------------------|
|                      |        | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Number              | Weighted Average Exercise Price |
| \$0 to \$2           | 188    | \$ 1.95                         | 0.08   | 188                 | \$ 1.95                         |
| \$2 to \$3           | 42,813 | 2.77                            | 2.67   | 42,813              | 2.77                            |
| \$3 to \$4           | 53,000 | 3.45                            | 3.63   | 44,666              | 3.52                            |

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|            |           |         |      |         |         |
|------------|-----------|---------|------|---------|---------|
| \$4 to \$5 | 58,150    | 4.64    | 3.93 | 58,150  | 4.64    |
| \$5 to \$6 | 29,000    | 5.07    | 3.14 | 29,000  | 5.07    |
| \$6 to \$7 | 821,838   | 6.07    | 0.75 | 811,420 | 6.07    |
|            | 1,004,989 | \$ 5.68 | 1.24 | 986,237 | \$ 5.70 |

At December 31, 2013, unrecognized compensation expense related to non-vested stock options was approximately \$46,000, which is expected to be recognized over a weighted average period of 1.0 years.

We issue common stock from previously authorized but unissued shares to satisfy option exercises and purchases under our Employee Stock Purchase Plan.

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**Employee Stock Purchase Plan** - In June 1996, we adopted an Employee Stock Purchase Plan (the “ESPP Plan”) under which eligible employees could purchase common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each six-month offering period. On November 29, 2005 we amended the ESPP Plan to provide that eligible employees may purchase common stock at a price equal to 95% of the fair market value of the common stock as of the end of each six-month offering period. There is no stock-based compensation expense related to our Employee Stock Purchase Plan because it is not considered a compensatory plan. The plan does not have a look-back feature, and has a minimal discount of 5% of the fair market value of the common stock as of the end of each six-month offering period. Participation in the ESPP Plan is limited to 6% of an employee’s compensation, may be terminated at any time by the employee and automatically ends on termination of employment. A total of 350,000 shares of common stock have been reserved for issuance. As of December 31, 2013 there were 108,959 shares available for future issuance under the ESPP Plan. We issued 7,196, 4,661, and 5,563 common shares under the ESPP Plan in 2013, 2012, and 2011, respectively.

**Dividends** - In April 2012, our board of directors declared a special cash dividend of \$1.15 per share. The dividend was paid on May 25, 2012 to shareholders of record as of May 11, 2012. The total amount of the dividend paid was \$25.5 million.

In November 2012, our board of directors declared a second special cash dividend of \$1.80 per share. The dividend was paid on December 17, 2012 to shareholders of record as of December 3, 2012. The total amount of the dividend paid was \$40.5 million.

**Share Repurchases** – In July 2011, we purchased 250,000 shares of our common stock at a price of \$2.90 per share from a shareholder in a privately negotiated transaction. In addition, we paid a broker commission of 4 cents per share in connection with the transaction.

9. COMMITMENTS AND CONTINGENT LIABILITIES

**Lease Commitments** – We own our principal office and research facility in Bedford, Massachusetts, which we have occupied since November 1997. We also conducted a portion of our activities in a leased facility in California in 2011 and 2012. We terminated that lease in September 2012 by making a one-time payment of \$15,000.

Rental expense, including the cost of the 2012 termination buyout of the California lease, was approximately \$0, \$25,000, and \$17,000 in 2013, 2012 and 2011, respectively.

**Litigation** - There are no material pending legal proceedings to which we are a party or to which any of our properties are subject which, either individually or in the aggregate, are expected to have a material adverse effect on our business, financial position or results of operations.

**Guarantees and Indemnification Obligations** – We enter into agreements in the ordinary course of business that require us: i) to perform under the terms of the contracts, ii) to protect the confidentiality of our customers’ intellectual property, and iii) to indemnify customers, including indemnification against third party claims alleging infringement of intellectual property rights. We also have agreements with each of our directors and executive officers to indemnify such directors or executive officers, to the extent legally permissible, against all liabilities reasonably incurred in connection with any action in which such individual may be involved by reason of such individual being

or having been a director or officer of the Company.

Given the nature of the above obligations and agreements, we are unable to make a reasonable estimate of the maximum potential amount that we could be required to pay. Historically, we have not made any significant payments on the above guarantees and indemnifications and no amount has been accrued in the accompanying consolidated financial statements with respect to these guarantees and indemnifications.

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10. BUSINESS SEGMENTS AND MAJOR CUSTOMERS

Upon the shutdown of the DSL Service Assurance Segment in 2013, we organize ourselves into a single segment that reports to the chief operating decision makers.

We conduct our operations in the United States and sell our products and services to domestic and international customers. Revenues were generated from the following geographic regions (in thousands):

|               | Year ended December 31, |           |           |
|---------------|-------------------------|-----------|-----------|
|               | 2013                    | 2012      | 2011      |
| United States | \$ 13,909               | \$ 12,158 | \$ 12,276 |
| Rest of world | 5,448                   | 5,146     | 3,923     |
|               | \$ 19,357               | \$ 17,304 | \$ 16,199 |

There were no single foreign countries from which we derived 10% or more of total revenue in the years ended December 31, 2013, 2012, and 2011.

The portion of total revenue that was derived from major customers was as follows:

|            | Year ended December 31, |   |      |   |      |   |
|------------|-------------------------|---|------|---|------|---|
|            | 2013                    |   | 2012 |   | 2011 |   |
| Customer A | 21                      | % | 5    | % | 10   | % |

11. EMPLOYEE BENEFIT PLAN

In 1994, we established a qualified 401(k) Retirement Plan (the "Plan") under which employees are allowed to contribute certain percentages of their pay, up to the maximum allowed under Section 401(k) of the Internal Revenue Code. Our contributions to the Plan are at the discretion of the Board of Directors. Our contributions were approximately \$189,000, \$233,000, and \$239,000 in 2013, 2012 and 2011, respectively.

12. NET INCOME PER SHARE

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

|  | Year ended December 31, |           |          |
|--|-------------------------|-----------|----------|
|  | 2013                    | 2012      | 2011     |
| Net income:                                |                         |           |          |
| Income from continuing operations          | \$ 3,752                | \$ 72,383 | \$ 3,581 |
| Loss from discontinued operations          | (1,156 )                | (76 )     | (1,014 ) |
| Net income                                 | \$ 2,596                | \$ 72,307 | \$ 2,567 |
| Shares outstanding:                        |                         |           |          |
| Weighted-average common shares outstanding | 22,543                  | 21,814    | 20,534   |

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|   |         |         |         |
|---|---------|---------|---------|
| Additional dilutive common stock equivalents            | 98      | 257     | 201     |
| Diluted shares outstanding                              | 22,641  | 22,071  | 20,735  |
| Basic net income per share:                             |         |         |         |
| Basic net income per share from continuing operations   | \$ 0.17 | \$ 3.32 | \$ 0.17 |
| Basic net loss per share from discontinued operations   | (0.05 ) | (0.00 ) | (0.05 ) |
| Basic net income per share                              | \$ 0.12 | \$ 3.32 | \$ 0.12 |
| Diluted net income per share:                           |         |         |         |
| Diluted net income per share from continuing operations | \$ 0.16 | \$ 3.28 | \$ 0.17 |
| Diluted net loss per share from discontinued operations | (0.05 ) | (0.00 ) | (0.05 ) |
| Diluted net income per share                            | \$ 0.11 | \$ 3.28 | \$ 0.12 |

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For the years ended December 31, 2013, 2012 and 2011, options to purchase 823,338, 821,838, and 2,518,914 shares of common stock at weighted average exercise prices of \$6.07, \$6.07, and \$4.62 per share, 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 shares and thus would be anti-dilutive.

12. QUARTERLY RESULTS OF OPERATIONS – UNAUDITED

The following table is a summary of certain items in the consolidated statements of income and comprehensive income for each of our quarters in the two-year period ended December 31, 2013 (in thousands, except per share data). The impact of the discontinued operations as described in Note 4 is included in all periods. Certain amounts differ from those previously reported on Form 10-Q due to the effect of discontinued operations.

|   | 2013 Quarters Ended |          |              |             |
|---|---------------------|----------|--------------|-------------|
|   | March 31            | June 30  | September 30 | December 31 |
| Revenue                                       | \$ 4,979            | \$ 4,427 | \$ 4,314     | \$ 5,637    |
| Operating income before patent related income | 2,202               | 543      | 1,039        | 754         |
| Income from patent arrangement                | 780                 | -        | -            | -           |
| Income from continuing operations             | 1,972               | 465      | 790          | 525         |
| Income (loss) from discontinued operations    | (115 )              | (158 )   | (1,943 )     | 1,060       |
| Net income (loss)                             | 1,857               | 307      | (1,153 )     | 1,585       |
| Net income (loss) per share – basic           | \$ 0.08             | \$ 0.01  | (\$ 0.05 )   | \$ 0.07     |
| Net income (loss) per share – diluted         | \$ 0.08             | \$ 0.01  | (\$ 0.05 )   | \$ 0.07     |
|   | 2012 Quarters Ended |          |              |             |
|   | March 31            | June 30  | September 30 | December 31 |
| Revenue                                       | \$ 4,161            | \$ 3,514 | \$ 4,771     | \$ 4,858    |
| Operating income before patent related income | 1,120               | 390      | 1,767        | 1,766       |
| Gain on sale of patent assets                 | -                   | 71,226   | 15,167       | -           |
| Income from patent arrangement                | -                   | -        | -            | 1,121       |
| Income from continuing operations             | 1,167               | 54,938   | 10,272       | 6,006       |
| Income (loss) from discontinued operations    | (49 )               | (12 )    | 25           | (40 )       |
| Net income                                    | 1,118               | 54,926   | 10,297       | 5,966       |
| Net income per share – basic                  | \$ 0.05             | \$ 2.52  | \$ 0.46      | \$ 0.27     |
| Net income per share – diluted                | \$ 0.05             | \$ 2.49  | \$ 0.46      | \$ 0.26     |

Quarterly amounts may not sum to annual amounts due to rounding and dilution.

### 13. OFF-BALANCE SHEET ARRANGEMENTS

We do not currently have any arrangements with unconsolidated entities, such as entities often referred to as structured finance, special purpose entities, or variable interest entities which are often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Accordingly, we are not exposed to any financing, liquidity, market or credit risk if we had such relationships.

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During 2011 and 2012 we disclosed that we had a patent arrangement with an unaffiliated third party that we classified as a variable interest entity. We also disclosed that: i) we had no equity interest in this entity; ii) we were not contractually obligated to fund this entity, therefore our maximum exposure to loss as a result of our involvement with this entity was zero; iii) we may receive royalties in the future if certain conditions are met; iv) we were not the primary beneficiary of this entity; v) we have not consolidated this entity's results into our financial statements, therefore we carried the assets and liabilities of this entity in our balance sheet at zero; and vi) prior to September 30, 2012, this arrangement had no impact on our results of operations, financial position or cash flows in any previous periods.

In August 2012, certain contractual provisions of the arrangement were amended. As a result, the arrangement was no longer considered a variable interest entity under generally accepted accounting principles, and we ceased to classify it as such once the amendment was signed.

## FINANCIAL STATEMENT SCHEDULE

Schedule II - Valuation and Qualifying Accounts – Years ended December 31, 2013, 2012, and 2011  
(in thousands)

| Col. A                                      | Col. B                               | Col. C(1)                           | Col. C(2)                       | Col. D                               | Col. E                         |
|---|--------------------------------------|-------------------------------------|---------------------------------|--------------------------------------|--------------------------------|
|   | Balance at<br>Beginning<br>of Period | Charged to<br>Costs and<br>Expenses | Charged<br>to Other<br>Accounts | Deductions<br>Charged to<br>Reserves | Balance<br>at End<br>of Period |
| Allowance for doubtful accounts receivable: |                                      |                                     |                                 |                                      |                                |
| 2013  | \$20                                 | \$-                                 | \$-                             | \$-                                  | \$20                           |
| 2012  | \$30                                 | \$-                                 | \$-                             | \$10                                 | \$20                           |
| 2011  | \$30                                 | \$-                                 | \$-                             | \$-                                  | \$30                           |
| Inventory reserves:                         |                                      |                                     |                                 |                                      |                                |
| 2013  | \$-                                  | \$-                                 | \$-                             | \$-                                  | \$-                            |
| 2012  | \$1,403                              | \$126                               | \$-                             | \$1,529                              | \$-                            |
| 2011  | \$989                                | \$450                               | \$-                             | \$36                                 | \$1,403                        |
| Warranty reserves:                          |                                      |                                     |                                 |                                      |                                |
| 2013  | \$10                                 | \$-                                 | \$-                             | \$10                                 | \$-                            |
| 2012  | \$-                                  | \$12                                | \$-                             | \$2                                  | \$10                           |
| 2011  | \$-                                  | \$-                                 | \$-                             | \$-                                  | \$-                            |
| Deferred tax asset valuation allowance:     |                                      |                                     |                                 |                                      |                                |
| 2013  | \$-                                  | \$-                                 | \$-                             | \$-                                  | \$-                            |
| 2012  | \$40,476                             | \$-                                 | \$-                             | \$40,476                             | \$-                            |
| 2011  | \$41,759                             | \$-                                 | (\$1,283 )                      | \$-                                  | \$40,476                       |

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our co-chief executive officers and chief financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our co-chief executive officers and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Evaluation of Changes in Internal Control Over Financial Reporting

Under the supervision and with the participation of our management, including our co-chief executive officers and chief financial officer, we concluded that there were no changes in our internal control over financial reporting that occurred during the quarterly period ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13(a)-15(f) under the Exchange Act. Under the supervision and with the participation of our management, including our principal co-executive officers and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. Based on our evaluation under the framework in Internal Control — Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2013.

The effectiveness of our internal control over financial reporting as of December 31, 2013 has been audited by McGladrey LLP, an independent registered public accounting firm, as stated in their audit report which is included herein.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 of Form 10-K is incorporated by reference from the information contained in the sections captioned “Directors and Executive Officers”, “Corporate Governance” and “Section 16(a) Beneficial Ownership Reporting Compliance” in the Proxy Statement that will be delivered to our shareholders in connection with our May 21, 2014 Annual Meeting of Shareholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the section captioned “Executive Compensation” in the Proxy Statement that will be delivered to our shareholders in connection with our May 21, 2014 Annual Meeting of Shareholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the section captioned “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters” in the Proxy Statement that will be delivered to our shareholders in connection with our May 21, 2014 Annual Meeting of Shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information, if any, required by Item 13 of Form 10-K is incorporated by reference from the information contained in the sections captioned “Corporate Governance” and “Certain Relationships and Related Transactions” in the Proxy Statement that will be delivered to our shareholders in connection with our May 21, 2014 Annual Meeting of Shareholders.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated by reference from the information contained in the section captioned “Independent Accountants” in the Proxy Statement that will be delivered to our shareholders in connection with our May 21, 2014 Annual Meeting of Shareholders.



## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULE

The following documents are filed as part of this report:

## (a) Financial Statements and Exhibits:

|  | Page |
|--|------|
| (1) Consolidated Balance Sheets as of December 31, 2013 and 2012   | 37   |
| Consolidated Statements of Income and Comprehensive Income for each of the three years in the period ended December 31, 2013 | 38   |
| Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2013                      | 39   |
| Consolidated Statements of Stockholders' Equity for each of the three years in the period ended December 31, 2013            | 40   |
| Notes to Consolidated Financial Statements   | 41   |
| (2) Schedule II - Valuation and Qualifying Accounts  | 57   |

## (3) Exhibits:

The exhibits listed below are filed with or incorporated by reference in this report.

| Exhibit No. | Description of Exhibit   |
|-------------|--|
| 2.1†        | Wireless Portfolio Patent Purchase Agreement, dated as of April 26, 2012, by and between Aware, Inc. and Intel Corporation (filed as Exhibit 2.1 to the Company's Form 10-Q/A for the quarter ended June 30, 2012 and incorporated herein by reference).             |
| 2.2         | DSL Patent Purchase Agreement, dated as of August 22, 2012, by and between Aware, Inc. and TQ Delta, LLC (filed as Exhibit 2.1 to the Company's Form 8-K filed with the Securities and Exchange Commission on August 24, 2012 and incorporated herein by reference). |
| 3.1         | Amended and Restated Articles of Organization, as amended (filed as Exhibit 3.1 to the Company's Form 10-K for the year ended December 31, 2008 and incorporated herein by reference).   |
| 3.2         | Amended and Restated By-Laws (filed as Exhibit 3.1 to the Company's Form 8-K filed with the Securities and Exchange Commission on December 10, 2007 and incorporated herein by reference).   |
| 10.1*       | 1996 Stock Option Plan, as amended and restated (filed as Annex A to the Company's Definitive Proxy Statement filed with the Securities and Exchange Commission on April 11, 2000 and incorporated herein by reference).   |
| 10.2*       | 1996 Employee Stock Purchase Plan, as amended and restated (filed as Exhibit 99.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on November 29, 2005 and incorporated herein by reference).                          |
| 10.3*       |  |

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- Form of Indemnification Agreement for Directors and Officers of Aware, Inc. (filed as Exhibit 10.1 to the Company's Form 8-K filed with the Securities and Exchange Commission on February 22, 2011 and incorporated herein by reference).
- 10.4\* 2001 Nonqualified Stock Plan (filed as Exhibit 99(d)(4) to the Company's Schedule TO filed with the Securities and Exchange Commission on March 3, 2003 and incorporated herein by reference).
- 10.5\* Form of Nonqualified Stock Option Agreement under the 2001 Nonqualified Stock Plan for options granted to executive officers and directors prior to May 21, 2008 (filed as Exhibit 10.6 to Company's Form 10-K for the year ended December 31, 2006 and incorporated herein by reference).
- 10.6\* Form of Nonqualified Stock Option Agreement under the 2001 Nonqualified Stock Plan for options granted to executive officers and directors from and after May 21, 2008 (filed as Exhibit 10.8 to Company's Form 8-K on May 22, 2008 and incorporated herein by reference)
- 10.7\* Form of Unrestricted Stock Award for outside directors of Aware under the 2001 Nonqualified Stock Plan (filed as Exhibit 10.1 to Company's Form 8-K filed with the Securities and Exchange Commission on July 28, 2010 and incorporated herein by reference).

- 10.8\* Form of Unrestricted Stock Award for officers of Aware under the 2001 Nonqualified Stock Plan (filed as Exhibit 10.2 to Company's Form 8-K filed with the Securities and Exchange Commission on July 28, 2010 and incorporated herein by reference).
- 10.9 Asset Purchase Agreement by and between Aware, Inc. and Lantiq Broadband Holdco, Inc. and Lantiq Deutschland GmbH dated October 14, 2009 (filed as Exhibit 10.8 to Company's Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.12\* Form of Unrestricted Stock Award for executive officers and directors of Aware, Inc. under the 2001 Nonqualified Plan (filed as Exhibit 10.1 to the Company's Form 8-K filed with the Securities and Exchange Commission on April 4, 2013 and incorporated herein by reference).
- 21.1 Subsidiaries of Registrant.
- 23.1 Consent of Independent Registered Public Accounting Firm.
- 23.2 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certification of co-Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of co-Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101\*\* The following financial statements from Aware, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2013, formatted in XBRL (eXtensible Business Reporting Language), as follows: (i) Consolidated Balance Sheets as of December 31, 2013 and December 31, 2012; (ii) Consolidated Statements of Income and Comprehensive Income for the Years Ended December 31, 2013, December 31, 2012 and December 31, 2011; (iii) Consolidated Statements of Cash Flows for the Years Ended December 31, 2013, December 31, 2012 and December 31, 2011; (iv) Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2013, December 31, 2012 and December 31, 2011; and (v) Notes to Consolidated Financial Statements.

†Portions of this exhibit are omitted and were filed separately with the Securities and Exchange Commission pursuant to the Company's application requesting confidential treatment under Rule 24b-2 of the Securities Exchange Act of 1934, as amended.

\*Management contract or compensatory plan.

\*\*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto shall not be deemed filed for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

By: /s/ Kevin T. Russell  
Kevin T. Russell  
co-Chief Executive Officer &  
co-President  
General Counsel

By: /s/ Richard P. Moberg  
Richard P. Moberg  
co-Chief Executive Officer & co-President  
Chief Financial Officer (Principal Financial and Accounting  
Officer)

Date: February 18, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 18th day of February 2014.

| Signature  | Title   |
|--|---|
| /s/ Kevin T. Russell<br>Kevin T. Russell           | co-Chief Executive Officer, co-President,<br>General Counsel & Director<br>(co-Principal Executive Officer)   |
| /s/ Richard P. Moberg<br>Richard P. Moberg         | co-Chief Executive Officer, co-President,<br>Chief Financial Officer & Director<br>(co-Principal Executive Officer)<br>(Principal Financial and Accounting Officer) |
| /s/ John S. Stafford, Jr.<br>John S. Stafford, Jr. | Chairman of the Board & Director  |
| /s/ John S. Stafford, III<br>John S. Stafford, III | Director  |
| /s/ Adrian F. Kruse                                | Director  |

Adrian F. Kruse

/s/ Brian D. Connolly  
Brian D. Connolly

Director

/s/ Brent P. Johnstone  
Brent P. Johnstone

Director

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